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CENTRAL REPORT

HONDURAS - FINANCIAL SECTOR ASSESSMENT

A Report for
the Central Bank of Honduras
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Honduras

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1.0 EXECUTIVE SUMMARY

1.1 Overview of the Financial Sector and Introduction to the Report.- The Honduran financial sector is composed primarily of private sector institutions but nonetheless has a significant public sector presence. Of greatest importance is the Central Bank of Honduras (BCH) which not only carries out typical central banking functions but is also involved in a number of other activities that may detract from its ability to undertake the new responsibilities that inevitably arise in the process of financial reform and liberalization. As one of its units, the BCH contains the Superintendency of Banks (SB) which is charged with oversight of the system. While at a technical level the SB compares quite well with similar institutions in other Latin American countries, it lacks certain essential powers to deal effectively with potentially insolvent banks. Among the other public sector financial institutions are: an insolvent development finance company that is being liquidated, a very small bank for municipalities, and an important agricultural development bank that is preparing to undergo a major and badly needed program of rehabilitation.

The predominant private sector financial institutions in Honduras are the commercial banks, of which a few are mixed capital with marginal public sector participation. The savings and loan associations are much smaller in size and fewer number, and several of them have common ownership with commercial banks. Finance companies in Honduras are not dedicated to development finance, as in most other Latin American countries, but are rather part of the informal, non-regulated financial sector. In fact, informal financial markets (IFMs) are highly important in Honduras and include a wide variety of agents, institutions and arrangements that extend far beyond finance companies and moneylenders and probably provide financial services to a larger proportion of the Honduran population than do formal financial institutions. The other financial institutions to be examined in this report are pension funds, insurance companies and the recently-created securities market. Although pension funds and insurance companies have received virtually no analytical attention in Honduras they are nonetheless potentially an important source of long-term funds.

Honduras has recently embarked on a series of major economic reforms that seek to rekindle growth based on a larger role for the private sector -- wherein entrepreneurs respond to signals provided by prices generated in relatively undistorted and competitive markets. However, a well-functioning financial system is essential for this approach to lead to a resurgence of economic growth. Only an efficient and growing financial system can mobilize adequate domestic savings to finance the new activities that will arise as entrepreneurs respond to more appropriate price signals, and only an efficient and properly motivated system can allocate these savings to activities with the best prospects. The focus of the analysis in this report is thus on the adequacy of existing financial markets and institutions in Honduras -- and the policy framework underlying them -- to provide the required basis for the resurgence of economic growth that is the desired outcome of the economic reforms already underway.

The following analysis reveals that there is much to be done to strengthen the financial sector in Honduras so that it can fulfill its necessary role. Moreover, even though greater reliance is to be placed on private sector initiative, major reforms will be required in public sector policies and institutions to provide essential infrastructure and appropriate incentives. For example, although low-interest BCH rediscounts may seem a plausible way to stimulate productive investments, they instead discourage deposit mobilization and promote dependent financial intermediaries that come to focus primarily on capturing subsidized credits for their owners and managers. In addition, if the public sector fiscal deficit cannot be significantly reduced and financed in a way that does not substantially tax the financial system, it will be far more difficult to provide the private sector with the financing that it requires to play a leading role in the resurgence of economic growth in Honduras.

The following executive summary covers briefly each of the key elements that must be taken into account in designing a strategy for the development of a financial sector supportive of renewed economic growth in Honduras. The macro-economic context and, in particular, the main features of the government's policy framework for the financial sector are examined. Monetary management, the instruments of monetary control and the ability of the BCH to carry out functions essential for financial reform are analyzed, with particular attention to the regulation and supervision of financial intermediaries by the SB. The performance of the main private sector financial institutions is evaluated, including especially commercial banks, savings and loan associations, pension funds and insurance companies, and the recently-created securities market. The importance of IFMs is also examined and, in particular, the possible lessons from IFMs for policy makers and managers of formal financial institutions. Based on this analysis, the key components of a strategy for the financial sector are outlined, including not only high priority adjustments in the policy environment but also actions to strengthen specific financial institutions in both the public and private sectors.

1.2 Macro-Economic Background.- Like many developing countries, especially in Latin America, Honduras experienced a series of external shocks during the 1980s that reduced prospects for future economic growth and continuing development. Many of these external shocks increased the need to undertake basic economic policy reforms but, at the same time, made these needed reforms more painful, and hence more politically difficult, to carry out. In many countries, for example, deteriorating terms of trade during the 1980s created balance of payments problems that led governments to place further restrictions on imports -- thereby exacerbating the bias toward policies of inefficient import substitution -- rather than pursuing more far-sighted policies of export-oriented trade liberalization.

Honduras itself had until recently followed policies of promoting industrialization through import substitution, but now has embarked on a major program of trade and tariff reform and liberalization. This program bodes well for future economic development and sustainable growth in Honduras -- especially if these measures can be complemented by a major reform of the financial sector that would allow more resources to be mobilized domestically and to be allocated to their most efficient uses.

The 1980s brought to the fore not only the importance of trade reform for Honduras but also the need to deal with a growing fiscal imbalance. The series of external shocks that began in the late 1970s had led Honduras to rely more heavily on its public sector, using increased public sector investment to attempt to lay the basis for future growth, along with increased public sector employment to stimulate the economy in the short run. Not only were these programs less successful than had been anticipated, but they also had to be financed.

As government revenues failed to keep pace with the growth in government expenditures, the growing fiscal deficit was financed primarily by increases in foreign debt. After foreign credit became virtually unobtainable from commercial sources, Honduras turned more and more to borrowing from foreign governments and international agencies and ultimately to the accumulation of external arrears. Faced with a long-standing problem that has now reached crisis proportions in the form of an unmanageably large foreign debt (approximately US$3.3 billion as of June 1990) and continuing insupportable public sector fiscal deficits, the new Honduran Government has recently initiated a major program of fiscal reform along with various proposals to deal with its foreign debt and external arrearages.

1.3 The Fiscal Situation.- The trade reforms already underway, especially if complemented by significant financial sector liberalization, can help to lay the basis for future growth and economic development in Honduras. However, successful fiscal reform is also essential for the Honduran economy in general and for the financial sector in particular. Now that the public sector fiscal deficit can no longer be financed in any significant way through continued foreign borrowing, it must be financed domestically.

Financing a significant fiscal deficit through the domestic financial system inevitably means fewer resources available for the private sector -- and thereby compromises the benefits that might otherwise be obtained from trade liberalization and other market oriented reforms. Moreover, financing the fiscal deficit through non-transparent means (e.g., monetary expansion leading to inflation or excessive and unremunerated reserve requirements against deposits that act as a tax on the financial system) will reduce further the resources available to the private sector as such policies reduce the ability of the financial system to mobilize domestic savings. In addition, savings mobilization through the domestic financial system will be further compromised by unresolved foreign debt problems and resulting threats of large and sudden devaluations.

The progress made to this point in solving the crucial problem of the public sector fiscal deficit has been significant. Tax collections have increased substantially, not only because of changes in tax laws but also through better collection efforts. On the expenditure side, however, less progress has been made as the substantial reduction that was hoped for has not yet been achieved. For this reason, the longer-term fiscal outlook remains uncertain.

Losses due to exchange rate differences continue to be transferred from other sources to the financial statements of the BCH. These losses are basically due to "Depositos Atrasados" that the BCH owes to the private banks that will continue to affect the BCH's "Other Net Assets" account for some time in the future. With respect to this problem, it should also be noted that foreign assets and liabilities are not adequately dealt with because of the lack of appropriate policies or reserves against possible losses. For example, the BCH should protect itself against fluctuations in the value of its liabilities denominated in foreign currency by holding assets that are similarly denominated.

Until the public sector fiscal situation has been resolved in a permanent rather than a temporary way, it will be difficult to convince the Honduran public to place the kind of confidence in domestic financial assets that is essential for successful deposit mobilization. Nonetheless, the fiscal improvement experienced during the first half of 1991, under a program with the IMF, has contributed to a recovery of confidence in the Lempira that has been reflected in a gradual remonetization of the economy thereby bringing about a significant gain in foreign exchange reserves at the BCH. An increase in interest rates also appears to have been crucial causal factor by reducing the demand for credit and making self-financing through capital repatriation more attractive.

It may, however, be premature to predict continuing success in the following months because of normal year-end fiscal and monetary problems together with uncertainty in projected disbursements by international agencies. In any case, both monetary and fiscal policies continue to point in the right direction. Moreover, the reduced demand for credit by the public sector should bring about a gradual reduction in interest rates that should stimulate the demand for credit by the private sector and thereby help to initiate a reactivation of the economy. To permit this "crowding in" to occur, it is essential to reduce the burden of reserve requirements as proposed below.

1.4 Government Credit Policies.- The Honduran Government has recognized that the availability of credit to the private sector may not be adequate and has taken certain steps to attempt to insure that more credit flows to the private sector. However plausible these steps may seem, they have nonetheless been misguided in two fundamental ways. First, they do not deal directly with the essential problem -- the need for a direct attack on whatever imperfections might be inhibiting the flow of credit to the private sector in general and to priority groups and activities in particular. Second, they impose remedies that are not only likely to fail but also to curtail further the availability of credit to the private sector.

Government programs of directed credit at below-market interest rates targeted to priority groups and activities discourage deposit mobilization. In some cases, the lower rates charged to borrowers are subsidized by lower rates paid to depositors, and in other cases trust funds or BCH rediscounts provide financial intermediaries with sources of funds that are cheaper than deposits. With reduced deposit mobilization, the total amount of funds available for private sector credit shrinks. Traditional directed credit programs also overlook two fundamental principles: (1) increases in domestic credit not validated by an increase in the demand to hold domestic financial assets will leak out through the loss of foreign exchange reserves or through inflation; and (2) targeted credit is incompatible with a market-oriented economy in which private agents are free to select the activities most profitable to them.

The example of credit targeted to the Honduran agricultural sector not only provides a clear illustration of the results of directed credit programs but can also provide the basis for certain recommendations, some of which could be implemented in the short run. According to official figures, the amount of credit being allocated to Honduran agriculture is high compared to most other Latin American countries, both relative to agricultural output and as a proportion of total banking system credit. Nonetheless, Honduran agriculture is widely believed to be in a bad state.

This suggests, on one hand, that credit is not the basic problem; rather, it is inadequate prices and markets, inadequate land tenure arrangements, inadequate research and extension, inadequate rural infrastructure, etc. -- problems that must be dealt with directly and cannot be resolved through credit. On the other hand, much of the low-interest credit targeted to agriculture is clearly being sought for the subsidies involved and being diverted to other activities with higher rates of return (including capital flight). Moreover, banks that have depended heavily on BCH rediscount lines for agriculture tend to have poor deposit mobilization and loan recovery performance.

Directed credit lines also involve high transaction costs for both lenders and borrowers as the result of attempts to target credit to approved recipients and activities and to monitor its use. The existence of these high transaction costs suggests that, if interest rates were raised to market levels, directed credit lines might cease to have much relevance. In particular, if the interest rate charged to financial intermediaries for such funds was continually adjusted to the marginal cost of mobilizing deposits (including the cost implied by reserve requirements) financial intermediaries would have less interest in utilizing these funds, subsidy seekers would largely lose interest in accessing these funds, and the BCH would be able to cover the effective cost of providing these funds. The rate of interest for rediscount funds was recently raised twice by the BCH which resulted in a substantial reduction in the demand for such funds, thereby confirming the foregoing argument.

The reduction in the amounts outstanding under directed credit lines could be compensated by an offsetting reduction in required reserves. Such a compensated reduction would not only leave monetary aggregates unchanged but would also decrease the costs and increase the incentives for financial intermediaries to mobilize deposits. Reductions in directed credit lines and reserve requirements, along with a reduction in the public sector fiscal deficit, can be key elements in a policy reform program to enhance the performance of the financial sector. Moreover, current high and unremunerated reserve requirements result in high spreads that reduce the demand for credit and thus do not permit the resources freed by the public sector to be channeled to the private sector.

Even though the fiscal deficit may not have been permanently reduced and there is a continuing danger that it could return to a high level, a gradual reduction in reserve requirements would be consistent with the reduction in BCH credit that has resulted from the increase in interest rates on rediscounts. However, before taking this step there should be a firm commitment to maintain tight control on rediscounts for basic grains since the demand for these rediscounts could increase sharply if the interest rate subsidy for basic grains is not removed.

1.5 Monetary Management.- With a reduction in the public sector fiscal deficit to manageable proportions and the financing of that deficit in ways consistent with the transparent and efficient operation of financial markets (that is, without excessive and unremunerated reserve requirements or inflationary monetary expansion) it becomes both possible and necessary to improve the instruments of monetary management. Moreover, Honduras has made significant progress in two other areas that also both permit and required improved monetary management. First, the overvaluation of the exchange rate has been greatly reduced and the foreign exchange market has been partially unified and made more flexible (although more remains to be done, as discussed in more detail in a subsequent chapter). Second, some progress has been made in interest rate liberalization so that interest rates can begin to be managed through modern instruments of monetary policy rather than through direct controls. With the exchange rate and interest rates free to reflect underlying market forces, and without the need to finance an excessive public sector fiscal deficit through nontransparent means, it becomes possible for the BCH to guide interest rates and the exchange rate in ways that can promote the long-run development of Honduran financial markets and the growth of Honduran economy in general. It also becomes necessary for the BCH to do so.

Three elements are essential for the BCH to be able to carry out its crucial role of monetary management effectively. First, it must have fewer responsibilities but more power and independence to fulfill appropriate responsibilities. The role of the BCH should be limited to managing the financial sector; it should not be involved directly with other aspects of the Honduran economy. In order to have the necessary power and independence to act for the overall long-run good of the Honduran economy, its Board of Directors must be constituted and appointed to be free from direct intrusions by other Government entities and from narrow private sector interests. Initially, it should not have representatives of the private sector or the banking system, as this reflects earlier periods in which central banks had a private origin and nowadays can be a source of pressure that can make it difficult to achieve monetary stability. Additionally, the terms of its members should no coincide with the term of the government. Moreover, the terms of members should be successive and overlapping so that the Board of Directors is not dominated completely by the government in power. Finally, the president of the BCH should not be in change of the government's economic team because this will involve the BCH in all aspects of economic policy, many of which are far from the BCH's basic responsibilities of monetary stability and oversight of the financial system.

Second, the BCH must have an appropriate organizational structure and a staff with adequate skills to analyze the conditions of the financial sector and the Honduran economy in general, to design a monetary program and to implement that program. A variety of organizational changes could improve the functioning of the BCH (e.g., increased decentralization with better internal controls), but most important is that the new organizational structure serve the essential functions of the BCH and not reflect its various inappropriate activities. A program of technical assistance and training for staff, especially in the key Economic Studies Department, should also be given high priority.

1.6 Monetary Instruments.- The third element -- the development of adequate monetary instruments -- requires somewhat more detailed discussion. As already indicated, reserve requirements must become an instrument to control monetary aggregates and not a mechanism to finance the public-sector fiscal deficit cheaply (and thereby tax depositors and the banking system) -- but this can only happen after the deficit has been brought under control. Buying and selling international reserves can be (and in fact has been in the past) an instrument of monetary control, but in the short run the BCH lacks adequate international reserves and in the long run this instrument should be targeted toward smoothing inappropriate fluctuations in the foreign exchange rate.

Buying and selling government bonds -- that is, open market operations -- is potentially a more appropriate instrument of monetary control than buying and selling international reserves. The BCH recently tried to implement open market operations through an auction system for government bonds

-- a good approach -- but unfortunately this was not successful as few bids were submitted. Failure resulted in part from the existence of tax-free government bonds that are redeemable on demand (which should be phased out) but primarily from the BCH's attempt to fix both price (the effective interest rate) and quantity simultaneously. The key feature of open market operations is that they allow the BCH to control either interest rates or monetary aggregates -- but not both simultaneously.

Another important instrument of monetary control is rediscount operations which, like buying and selling international reserves or open market operations in government bonds, control the monetary base and hence influence all monetary aggregates. Unfortunately, however, rediscount operations in Honduras have been governed primarily by various directed credit programs rather than by the need to manage overall liquidity. In addition to disrupting monetary control in general, the below-market interest rates associated with most directed credit programs have increased pressures for excessive expansion of the monetary base while reducing incentives for deposit mobilization, as already noted.

Short-term rediscounts should be used solely for monetary management and offered only at interest rates above the cost of mobilizing deposits. Long-term rediscounts might be used for development purposes -- but only if interest rates are raised to market levels and transaction costs are reduced. Financial intermediaries must take full responsibility for the risks on rediscounted loans, while the BCH must cease to be involved in client selection and the <u>ex-ante</u> evaluation of loans and only audit <u>ex-post</u> a sample of rediscounted loans. Moreover, as indicated below, the supply of long-term funds might be adequate without BCH rediscounts if policies toward pension funds and insurance companies were appropriate.

1.7 Interest Rate Control.- With adequate instruments of monetary control, attempts to control interest rates directly could be abandoned. Interest rate control as traditionally practiced in Honduras has focused on controlling rates on loans and has generally left rates on deposits free from control -- an approach that is totally inappropriate. Controls over interest rates on loans are at best ineffective as lenders can readily impose additional charges to raise rates to equilibrium levels no matter how diligent the regulatory authorities may be. At worst, controls over rates on loans can lead to the formation of economic groups to take advantage of low rates, can be a devise to enforce cartel arrangements and thereby promote monopoly profits, or can lead regulated financial institutions to divert their lending to informal markets -- something that has been widely observed in Honduras, as discussed below. On the other hand, arguments can be made for limited controls over interest rates on deposits in certain circumstances in order to prevent insolvent or risk-prone financial intermediaries from taking advantage of explicit or implicit deposit insurance that is not accompanied by adequate regulation and supervision of deposit-taking institutions.

Interest rates have been liberalized, but the government nonetheless continues to maintain a certain degree of control over interest rates in the private banking system. Interest rates on deposits have been freed from control, but banks must still announce the average interest rate that will be charged on loans during the following month, and this rate can only be adjusted up or down by two percentage points.

1.8 Exchange Rate Policy.- The foreign exchange market has been partially liberalized but certain vestiges of repression still remain:

-- imports of less than US$5,000 has been completely liberalized, but those above that amount have to be authorized beforehand using a declaration to the Registry of Foreign Debt;

-- repatriation of capital to a foreign head office is restricted;

-- exporters must sell as much as 70 percent of their foreign exchange receipts in the interbank market. Although the gap between the interbank market and the parallel market is not currently large, the possibility that the gap could grow in the future creates a disincentive for exports.

The complete liberalization of the foreign exchange market would tend to stimulate exports and capital inflows -- not only of financial capital but even more importantly of foreign investment.

In addition, exchange rate policy should be more flexible in order to permit the exchange rate to adjust with inflation. The gains in competitiveness that were achieved during 1990 are being lost during 1991 by maintaining the Lempira constant at 5.3 per dollar for eight months while prices have increased by 16 percent during the same period.

Liberalization and increased flexibility in the foreign exchange market could perhaps best be implemented through an auction system, since the exclusive right of the banking system to deal in foreign exchange does not otherwise allow for adequate competition. Permitting exchange houses to operate does not appear to be a good idea at this time, at least until the Superintendency is able to supervise their activities adequately.

1.9 Savings Mobilization.- In spite of the possible need to limit interest rates on deposits under certain circumstance, it is nonetheless crucial that interest rates on deposits not be set at levels that are negative in real terms or in ways that inhibit competition for deposits by financial institutions that are solvent and prudent. The performance of financial institutions in deposit mobilization has been poor in Honduras during the 1980s. Enhanced deposit mobilization is the only way that more funds can be made available on a sustainable basis to finance increased private sector investment. Many of the reasons for poor mobilization revolve around inadequate macro-financial policies that have already been discussed -- excessive fiscal deficits leading to a lack of confidence in domestic financial assets, high and unremunerated reserve requirements that tax deposits, availability of low-interest rediscounts that reduce incentives for financial institutions to mobilize deposits, etc. Even when these policies have been changed, financial institutions may nonetheless require training and technical assistance to promote a rapid response in deposit mobilization after years of neglect, especially of depositors in rural areas and of individuals of modest means.

1.10 Commercial Banks.- Commercial banks and other formal financial institutions in Honduras have often been harshly criticized for their failure to provide adequate financial services to the majority of the Honduran population and especially to individuals of modest means. In recent years, moreover, questions have also been raised about the solvency of certain banks. While some of these criticisms may be correct, they do not necessarily mean that Honduran bankers are by-and-large incompetent, lazy or dishonest. Rather, to the extent that the current condition of the Honduran banking system is problematic, this largely reflects inappropriate incentives facing bankers -- incentives that are mainly due to inappropriate government policies. For example, as long as interest rates on loans are below the rate of inflation, bank owners and managers will have clear incentives to lend only to those who have the best collateral and who are well known -- often friends and relatives or related economic groups -- rather than seeking out new clients who will be more costly to serve than current borrowers and who may also turn out to be more risky.

Among the fourteen commercial banks in Honduras, at least two or three have serious problems with respect to solvency. These problems are well known to the BCH and within the Honduran banking community, and in fact these banks are under a mild form of intervention ("supervision preventiva") by the SB. These solvency problems appear to have arisen mainly from non-performing loans and to have reached serious proportions because of the failure to act more aggressively to collect overdue loans or to make adequate provisions for loan losses (including the accrual of interest not collected). However, the legal collection process is slow and costly, while loan loss provisions are discouraged by tax policy. In addition, problem banks have tended to depend heavily on BCH rediscount lines (possibly for targeted and subsidized lending to riskier clients) and consequently to have neglected deposit mobilization.

Besides attacking these fundamental policy issues, a key question is what to do with problem banks to minimize subsequent losses. Unfortunately, there is no well-developed process in Honduras for recapitalizing, merging, selling or liquidating problem banks -- or having them rehabilitated by the SB. While such processes are being developed, it is crucial that precedents not be established of bailing out problem banks to the benefit of current owners and managers -- otherwise, the costs to the Honduran Government could extend far beyond the banks that may currently be insolvent, as strong incentives are created for excessive risk taking by other banks.

There may in fact already be other banks with potential solvency problems, but this is difficult to know in Honduras because of excessive concern for bank secrecy, together with tax incentives not to provision for non-performing loans and hence not to reveal their existence. Compared to most developing countries, relatively good information does exist about the financial condition of Honduran banks. Honduran banks all have external audits, and the firms that carry out these audits are highly competent; in fact, most bank audits are carried out by Honduran offices of major U.S. accounting firms. Most bank statements in Honduras have "qualified opinions" from their auditors for the reasons suggested above (e.g., accrual of interest on delinquent loans and inadequate loan loss reserves), but this information is generally available only to stockholders and to the SB. Moreover, as discussed in greater detail below, the SB has relatively good information about the financial condition of banks, but this information is also generally unavailable because of excessive concern for bank secrecy. Consequently, in spite of the <u>existence</u> of information, the lack of <u>availability</u> of information makes depositing in Honduran banks largely an act of blind faith -- because of the lack of explicit deposit insurance as well as the lack of information.

Banking in Honduras is becoming a riskier business. In part this is due to the recent upsurge in inflation that will require banks (and especially savings and loan associations, as discussed below) to adopt more flexible interest rate policies and to appreciate more fully the impact of interest rates on the profitability and cash flow positions of their borrowers.

More fundamentally, the process of financial liberalization that is being recommended to increase the efficiency of the Honduran financial system will not only give banks more freedom in decision making but will also expose them to greater competition. Financial liberalization not only entail programs to make interest rates more flexible but also involves policy changes that will increase competition among banks -- such as the reform of barriers that block the entry of new banks. Both theory and practice have shown that, if there is more than a small number of potential competitors (e.g., three or four), banking cartels or oligopolies that extract monopoly profits from their clients can only exist if they are aided by government regulations such high and arbitrary barriers to entry. For Honduras, this implies that applicants for bank charters should be required to supply adequate capital along with impeccable records of honesty and assurances of competence for potential owners and managers, but there should be no arbitrary or non-transparent requirements or untimely delays in approvals.

Three additional initiatives are implied by the foregoing discussion of the impact of financial liberalization on the Honduran banking system. First, accurate information about the current financial condition of banks must be more widely available on a timely basis so that potential depositors and others who may have dealings with Honduran banks can make well-informed decisions. Second, the Honduran Government must adopt an explicit policy toward deposit insurance. If there is to be official deposit insurance, then the Government must assure that there is adequate prudential regulation and supervision of insured institutions to avoid excessive risk taking. If there is not to be official deposit insurance, then the Government must make absolutely clear by both its statements and its actions that it will not bail out depositors or owners and managers of failed banks on an ex-post basis.

Third, programs of technical assistance and training for banks and bank staff should be initiated. Training and technical assistance programs will not be very helpful as long as inappropriate incentives and the inappropriate policies creating them have not been changed. However, once reform is underway, enhanced training and technical assistance will be crucial (e.g., how to deal with inflation and resulting high and variable interest rates, the use of cash flow analysis, learning from the techniques of client selection and loan recovery used by informal financial agents, etc.). Moreover, to finance this training and technical assistance and to assure its relevance and quality, the recipients should pay a portion of the costs commensurate with the direct benefits received.

1.11 Savings and Loan Associations.- The problems facing the six Honduran savings and loan associations should not be over-emphasized because they represent less than 10 percent of the Honduran banking system. Nonetheless, their problems are quite similar to those experienced by U.S. savings and loan associations -- long-term loans, many with fixed interest rates, in the presence of rising inflation and interest rates, together with efforts to diversify out of housing finance and into riskier operations for which they have little experience -- and at least one Honduran savings and loan is already believed to be insolvent.

Honduran savings and loan associations also face potential funding problems as they have become heavily dependent on low-interest rediscount lines from the BCH (which should not continue for the reasons discussed above) and on low-interest deposits from various pension funds (which cannot continue indefinitely). As discussed below in more detail, these pension funds will be unable to honor commitments to their beneficiaries if they continue to make deposits at interest rates than are highly negative in real terms. Moreover, the maturing of Honduran pension funds will eliminate their substantial surpluses of revenues over expenditures. In addition, higher interest rates on housing loans to compensate for higher inflation may cause cash flow problems for borrowers if conventional level-payment mortgages are used, since level payments in nominal terms imply payments that are high in real terms in the initial years of a loan. In fact, for all types of long-term lending, consideration may need to be given to some form of indexation of principal or capitalization of interest to deal with such potential cash flow problems.

1.12 Public-Sector Banks.- There are three public sector banks in Honduras, but of these only BANADESA, the agricultural development bank, warrants any serious attention. BANMA, the bank for municipal financing, never played any significant role in the Honduran financial sector, while CONADI, the investment finance company, has been insolvent for some time and is currently in liquidation.

The history of BANADESA is not unlike that of other agricultural development banks in Latin America. Attempts to provide targeted loans at subsidized rates of interest to priority borrowers and activities in the agricultural sector (e.g., small farmers, producers of basic grains and agrarian reform beneficiaries) have resulted in high operating costs and a very high proportion of non-performing loans -- due in part to the difficulty of dealing with such clients but more importantly to political intrusions. Recently, BANADESA management appears to have made serious attempts to bring costs under control, to improve the collection of overdue loans and even to minimize political intrusions, but the ultimate success of these efforts remains to be seen. To have any chance to be viable, BANADESA needs to focus on providing a full range of financial services in rural areas (including loans to non-farmers and especially deposit mobilization), to eliminate activities unrelated to providing such services (which have been the source of BANADESA's most serious losses), to develop incentive systems that reward autonomous branch managers for good performance, and, above all, to protect BANADESA from political intrusions. Until substantial progress is made in these respects, it would be a serious mistake to channel funds to recapitalize BANADESA or to finance its lending and other activities.

1.13 Superintendency of Banks.- The SB is largely well regarded by Honduran bankers and by foreign experts for its technical skills, but it nonetheless faces certain significant problems that will require additional strengthening of its technical capabilities and especially of its powers to deal with banking problems. Two of the most important areas have been noted above. First, the SB needs to deal with the problem of lack of public information about the financial condition of banks which, in turn, will require a clear recognition that banking secrecy applies only to information about deposits. As part of this, the SB also needs to improve the way it collects and organizes the data provided to it by the banks that it supervises. Second, the SB needs enhanced powers to deal with problem banks. The results of its bank analyses must lead not simply to recommendations but to actions that will ultimately be enforced either by the SB itself or by some other governmental agency to which it reports its findings. In addition, if the SB is to have responsibility for dealing with problem banks, it will need to expand its operational skills substantially to include areas of bank management. This will allow the SB to operate efficiently in selling, merging, or liquidating insolvent banks, or rehabilitating and recapitalizing them if this is deemed appropriate.

There are also a number of specific actions that might be taken to strengthen the SB's capabilities. First, it needs to focus its analytical work on capital adequacy. This, in turn, requires much greater attention to the quality of bank loan portfolios -- including not only the timeliness of loan repayments, but also loan concentration, lending to related parties and adequate documentation of borrowers' financial condition -- as well as the adequacy of provisions for non-performing loans and the overall credit administration capabilities of banks. One action along these lines would be to establish portfolio review and loan classification standards that would be applied by the banks themselves and then reviewed by their external auditors and finally by the SB itself.

It would also be useful to develop a credit information bureau to collect, organize and provide information about the overall exposure of the banking system to different borrowers. This could be helpful in monitoring loans to related parties as well as portfolio concentration. The SB could also consider developing a strong legal department not only to provide interpretations of laws and regulations but also to provide recommendations for on-going reform for banking legislation. In addition, a strong data processing and systems department would be useful to reformulate the way information is collected from banks and to expedite the handling of such information. New computer hardware and software and substantial amounts of training and technical assistance would subsequently be required to implement the new framework.

1.14 Pension Funds.- There are currently seven pension funds operating in Honduras, but three of these are very small. All seven of them initiated operations in the 1970s or 1980s. Because they are so new, they tend to have relatively large numbers of contributors compared to beneficiaries, so they are growing rapidly in total assets. In fact, they have already reached almost L. 2,000 million in total assets and are thus more than one third the size of the Honduran banking system.

In spite of their growth and size, as well as the many recent studies of financial markets in Honduras, only one serious study of pension funds could be found. Pension funds have also been neglected in terms of regulation and supervision, as the law provides few limits on their investments beyond the recommendation that prudence be emphasized over return. Currently, almost 50 percent of total pension fund assets are in government bonds and bank deposits, both of which have yields that are highly negative in real terms, and another 35 percent are in loans to beneficiaries, also at interest rates that are negative in real terms. This apparent emphasis on prudence, together with pressure to make low-interest loans to beneficiaries, is leading the pension funds toward rapid decapitalization. If they are to honor commitments to their contributors, they must find outlets for funds that provide yields that are positive in real terms. Furthermore, their current size and growth potential could make them a key element in Honduran financial markets, especially as providers of longer-term funds of which there is said to be a great deficiency.

1.15 Capital Markets.- Development of capital markets is necessary for Honduras not only to help to provide sources of longer-term financing for investment projects but also to provide instruments with market-determined rates of return that can enable institutions such as pension funds and insurance companies to earn positive real rates of return and thereby to protect their asset bases. As indicated above, such instruments do not appear to be widely available. For example, the Honduran Government uses a variety of non-transparent devices to avoid paying market rates of interest on its debt. It is essential for the development of capital markets -- and, as explained above, for the development of appropriate instruments for monetary management -- that the Honduran Government and the BCH issue instruments that can be freely traded in the capital markets of Honduras at market-determined rates of interest.

BCH rediscount lines at below-market rates of interest for long-term loans have also discouraged the development of instruments that could be traded in Honduran capital markets, as potential borrowers in capital markets prefer to seek subsidized funds through these rediscount lines. Although many individuals believe that the development of capital markets in Honduras is hindered mainly by the lack of supply of long-term funds, the foregoing discussion of pension funds suggests that this is not the case and that the main barrier is instead current government policies toward rediscount lines and the financing of the public sector fiscal deficit.

The recent creation of a securities exchange in Honduras is a promising development. However, as is widely recognized and discussed in detail elsewhere in this report, substantial technical assistance and training efforts will be necessary before this exchange can reach the efficiency and size that will allow it to contribute significantly to the development of financial markets in Honduras. This training and technical assistance can be focused most effectively if the process begins with the development of a strategic plan for the securities exchange.

It is also essential to provide the appropriate regulatory environment for the securities exchange to function, and a number of specific recommendations are made elsewhere in this report. While it is important eventually to write a law specifically for the securities exchange and to insure that this law is consistent with other Honduran laws and regulations, dealing with the specific issues detailed below should not wait. An important aspect of the regulatory environment is assurance of timely disclosure of relevant and accurate information so that participants in the market can make well-informed decisions -- a point that has also been stressed for the banking system. Because of the time required for the development and dissemination of information that will have adequate credibility, it is likely that trading on the securities exchange will develop first in government and BCH instruments, later in instruments issued by the banking system and only later in prime commercial paper and other debt and equity instruments of the non-financial private sector.

1.16 Informal Finance.- Informal financial markets (IFMs) in Honduras are highly diverse, may be almost as large as formal financial markets in the total volume of operations, and are certainly much larger in the number of clients served. The extreme diversity of IFMs makes it difficult to define them precisely, but the most common and useful definition focuses on the fact that they are unregulated, that is, they are not subject to the regulations and supervision that monetary authorities impose on formal financial markets and institutions. Nonetheless, Honduras presents an interesting case distinct from most other developing countries in that informal lenders are supposed to register with the BCH, to pay taxes on the volume of lending reported, and to be subject to interest rate limitations. The interesting issue is why any informal lenders would in fact register -- and more than 1,000 currently do. There are two important reasons: (1) interest rate limitations can easily be avoided (e.g., by mis-stating the amount of the loan); and (2) registration is necessary to have access to the legal system to enforce loan contracts.

IFMs demonstrate considerable flexibility in their operations, including taking advantage of the legal system and various aspects of the commercial code whenever the benefits exceed the costs. Their diversity and flexibility has allowed IFMs to serve far more clients than are served by formal financial markets and institutions, in spite of the hostility often expressed by formal sector agents and by policy makers and government officials charged with financial sector regulation. Before deciding on the appropriateness of such hostility, and consequently on the position that should be taken toward IFMs, it is essential to know more about their operations in Honduras. These operations are not well documented in large part because of official hostility, which has also led to severe under-estimation of the importance of IFMs.

Among the most common types of IFMs in Honduras are individual moneylenders, pawnshops, informal groups that pool savings and make loans, and a wide variety of traders, marketing agents and merchants, as well as friends and relatives. IFMs also include various types of more formal institutions (that are nonetheless informal in that their lending activities are not regulated by the monetary authorities) such as finance companies, leasing and credit card companies, non-governmental organizations (NGOs), and credit unions and other types of cooperatives. Most IFMs charge interest rates of 2 to 5 percent per month on loans, but rates sometimes range much higher, especially in cases of small amounts for short periods of time. Borrowers are willing to pay such rates because of the other terms and conditions of informal loans, especially the speed and flexibility and the absence of formalities that raise borrower costs or ration out potential borrowers completely. In short, lower transaction costs on informal loans can more than compensate for higher interest rates.

Another significant aspect of IFMs is their savings mobilization activities, which are extensive but largely undocumented. It is well known that credit unions mobilize deposits, and it is also widely recommended that they could enhance their viability if they did so more aggressively through higher interest rates and better service for depositors. In addition, however, many pawnshops, finance companies, credit card and leasing companies, and even merchants, traders and individual moneylenders, as well as informal groups, also mobilize deposits. They are successful in deposit mobilization primarily because they offer higher interest rates than formal financial intermediaries that are limited by high reserve requirements and low interest rates on loans. The interest rates paid by IFMs must be higher to compensate depositors for the real and perceived risks of depositing with IFMs rather than with formal financial institutions.

Some of the lessons that can be learned from the operations of IFMs in Honduras should be quite clear both for government policy makers and for operators of formal financial markets and institutions. If interest rates that formal financial institutions pay on deposits are repressed by high reserve requirements and discouraged by low-interest BCH rediscounts, potential depositors will seek outlets in IFMs for their savings -- which, however, may turn out to be more risky as well as more rewarding. For policy makers, an appropriate response is clearly greater incentives for deposit mobilization by formal financial institutions, along with clear and convincing statements that depositors in unregulated IFMs will not be bailed out by the Honduran Government if these IFMs become bankrupt. For operators of formal financial markets and institutions, much can be learned from the deposit mobilization techniques of IFMs and especially from the success of IFMs in mobilizing deposits from segments of the population that formal financial markets and institutions have traditionally neglected.

With respect to lending by IFMs, operators of formal financial markets and institutions can learn much about techniques of client selection and loan recovery that would allow these institutions to deal with the types of potential borrowers that they have neglected in the past (e.g., small-scale enterprises, small commercial farmers and others who live in rural areas). Formal lenders will also need to set interest rates freely and flexibly to reflect the full costs of dealing with these new types of clients -- otherwise, they will have no incentive to expand their client base. Policy makers must therefore come to recognize more clearly the importance of market-determined interest rates for formal lenders, together with the fact that attempts to repress IFMs will not only largely fail but will also drive up the costs of financial services for all users. There are undoubtedly many examples of the abuse of borrowers by informal lenders, but such abuses should be dealt with through the enforcement of laws and regulations that protect everyone against fraud and extortion and not through special regulations that inhibit the flexibility of IFMs to provide a wider range of financial services at lower cost.

There is an emerging view of IFMs that sees them in a much more favorable light and often recommends that they be incorporated in government and donor projects or linked with formal financial institutions. However, because of past neglect of IFMs in Honduras and elsewhere, more detailed study is needed to know about the impact of recommended interventions on IFMs and the likelihood of benefits for the overall economy. There are some examples of positive interventions in Honduras, such as the current program to strengthen credit unions in their ability to provide a wider array of financial services on a more sustainable basis. However, there are also examples of negative interventions, such as the programs that involve NGOs in targeted lending at below-market interest rates to small-scale enterprises. These programs have not only tended to compromise the viability of participating NGOs but have also achieved only limited outreach.

Programs to formalize IFMs may also sometimes be counter-productive, as IFMs may lose their flexibility and no longer be able to serve even their traditional clients efficiently. Programs to link IFMs with formal financial markets and institutions may also involve significant risks for the parties involved. More basic approaches, such as reducing the biases against bank lending to marketing agents and merchants, may be more effective in allowing funds to flow to neglected sectors of the economy. If the best that IFMs can do is to provide some lessons for policy makers and for the managers of formal financial market and institutions, along with some financial services for those who would not otherwise receive them, this is nonetheless a significant accomplishment.

1.17 A Strategy for Financial Sector Development.-

Broadly speaking, the following overall guidelines should characterize efforts to reform the financial sector of Honduras.

- Implement fiscal policies which will permit the government to operate with a balanced budget. To the extent possible, the financial sector should not be utilized as a source of incremental financing for the central government. Taxes, and other forms of financing for the central government, should be levied in a transparent manner.

- Policies and interventions in financial markets and capital markets should be directed at removing **distortions** from the financial system to permit market forces to efficiently allocate resources in the financial system.

- Policies and interventions should be directed at fostering **competition** in financial markets wherever possible. The more competition that exists in financial markets, the more efficient the markets. In the long run, financial resources will be allocated to their highest and best use in the economy.

- Care should be taken to insure that financial market and capital market strategy be **integrated**. This will insure the balanced development of both markets.

1.18 Specific Recommendations for Financial Sector Interventions.-

Macrofinancial Policy Reforms.-

- Reduce the public sector fiscal deficit such that it can be financed through transparent, market-oriented means that do not crowd out the private sector and consequently undermine investment.

- Unify the foreign exchange market by eliminating exchange controls that require exporters to surrender their foreign exchange to the BCH and importers to access foreign exchange through the BCH.

- Attempt to assure greater independence for the BCH and allow it to use monetary instruments for monetary control rather than for financing the public sector fiscal deficit and channeling funds at below market interest rates to the private sector.

- Improve the technical capabilities of the BCH to use the main instruments of monetary control, that is, open market operations, reserve requirements and rediscounts.

- To the extent that interest rate controls are not completely phased out, tie them to a market rate of interest such as that determined in the auction market for government bonds where the BCH would carry out its open market operations.

- As a first step, undertake:

    - a parallel reduction in reserve requirement and rediscounts;

    - a movement of the rediscount rate to market levels;

    - the remuneration of remaining required reserves at market rates; and

    - the initiation of open market operations through an auction system.

BCH Operational Reforms.-

- The focus of the BCH should be narrowed so that it is clearly responsible for monetary and financial sector policies and their implementation and not for a boarder range of economic or governmental activities.

- The BCH should have adequate autonomy and independence which will require modification of pertinent laws, including those covering the selection of members for its Board of Directors.

- The plan to reorganize and decentralize the BCH should be implemented, with some modifications, but only after the essential functions of the BCH have been clearly defined -- except that immediate attention should be given to improving internal controls and to developing an integrated accounting system for management information and financial control.

- The BCH should reform its rediscount policies so that short term credits are granted to banks only for liquidity management purposes and so that procedures for granting long term credits for development purposes are reformed. In both case, interest rates on rediscounts should be high enough to cover the costs of funds (including any foreign exchange risk) and not to discourage deposit mobilization by banks.

- The BCH should be assisted in obtaining training and technical assistance in a variety of areas, but especially with respect to the following:

- for the Department of Economic Studies so that it can play its essential role in developing the BCH's monetary program and in providing crucial information and analysis to highest level BCH management;

- for the Department of Credit to develop new approaches to handling rediscounts and for the initiation of open market operations; and

- for improving internal controls and developing an integrated financial system for management information and control.

Financial Institution Recommendations.-

- Facilitate the development of formalized, on-going training programs (described in Chapter 4, para.,4.181,) to assist financial institutions with the modernization and liberalization process that will inevitably result from policy recommendations recommended in Chapter 2.

- Provide technical assistance to the banking system, through the Superintendency of Banks, or through the Bankers' Association, to facilitate the implementation of **credit process management and credit review** related recommendations suggested in Chapter 7.

- As suggested in the specific recommendations under Chapter 4, para., 4.32, serious consideration should be given to liquidation or privatization of BANADESA. It will be difficult for market mechanisms to effectively intermediate financial resources in the agricultural sector while BANADESA continues to operate under pricing standards that are not market determined (and with different credit standards) in competition with the private sector (both the formal financial institutions and the informal financial system).

- Conduct a review of all existing legislation, Central Bank regulations and other constraints upon the banking system that inhibit open competition among financial institutions. Develop a plan to dismantle barriers to competition. The results of this survey must be incorporated into any overall plan to modernize current banking legislation.

Pension Fund and Insurance Company Recommendations.-

- Facilitate the development of a seminar, adapted to the Honduran context, on macro-financial issues, capital budgeting, bond yields and short term investment for the participation of pension plan managers and staff.

- Facilitate the development of a statistical data bank to record statistics on insurance claims. This will permit insurance premiums and reserves to be mathematically calculated.

Capital Market Recommendations.-

- Develop and implement a training program for the management and staff of the securities exchange as set forth in Chapter 6, para., 6.5.

- Facilitate the establishment of a commission to study and propose immediate partial reform to the existing legislative and regulatory framework as set forth in Chapter 6, para., 6.6.

- Carry out the specific legal recommendations as set forth in Chapter 6, para., 6.7.

Recommendations for the Superintendency of Banks.-

- Establish and implement clear, written guidelines and definitions for the banks so that periodic information submitted to the superintendency is uniform and can be utilized for effective monitoring of the banks' asset quality and financial health.

- Modify current strict interpretation of bank secrecy law so that there is ample disclosure of information regarding the financial health of financial institutions, to include information that will permit analysts to assess the quality of loan portfolios, other assets and earnings. Periodic reports by independent external auditors should be required and <u>should be available to the public upon request.</u>

- The Superintendency of Banks should establish clear minimum guidelines for **Credit Process Management** requirements at financial institutions. Standards must be set for information required to be available in credit files and other credit administration procedures. Standards established must be audited periodically in conjunction with asset/loan quality review. Banks with sub-standard credit process management must be sanctioned and forced to adhere to minimum standards.

- Banks should be required to establish internal credit review programs as part of their **Credit Process Management.** Existing loan classification standards should serve as the basis for each bank's credit review program. The Superintendency should, in turn, conduct periodic credit reviews to audit the programs established by the banks. As part of the credit review, the Superintendency must assess the adequacy of each bank's reserves set aside for loan losses. Banks must immediately establish any provisions required by the Superintendency as part of the credit review.

- Specifically, the Superintendency should require that financial institutions write off their worthless investments in CONADI

- The Superintendency should develop a practical **implementation plan** for dealing with sick financial institutions. Certain legislation which inhibits the power of the Superintendency to act swiftly and forcefully to intervene must be re-written. The implementation plan must address how runs on deposits will be handled and how to deal with the stockholders of the intervened institutions.

- o Once the plan is in place the Superintendency should move forcefully to intervene, liquidate or merge the existing financial institutions in the system that are failing.

- o Tax legislation must be overhauled to permit banks to deduct loan losses and provisions for losses from taxable income.

- o Conduct a computer systems review to determine optimum hardware and software requirements of the Superintendency needed to manage the desired data base. The system should be designed to permit electronic reporting by financial institutions.

- o Design and implement a training program for Superintendency personnel stressing, financial analysis, credit review and asset evaluation and how to monitor economic groups and lending to related parties. Additionally, training programs should be implemented in areas such as the mathematical review of insurance premiums and mathematical reserves to permit the Superintendency to monitor the insurance companies.

Informal Financial Market Recommendations.-

- o It is clear that far too little is known about this major component of the Honduran financial system, so that any additional studies of financial markets in Honduran should give high priority to both surveys and case studies of IFMs.

- o Any additional regulation of IFMs in Honduran should focus on protection of investor funds and should not inhibit competition and innovation in IFMs through attempts at enforcing interest rate controls or similar regulations.

- o Interventions to strengthen specific agents in Honduran IFMs should focus on making these agents financially viable and should not involve them in programs to strengthen their clients that are patterned after traditional directed credit programs.

- o Agents in IFMs can provide better service to their clients if they can obtain credit from the formal system on competitive terms, and this should include pawnbrokers, marketing agents and other informal lenders and not just credit unions and NGOs.

2.0 MACRO-FINANCIAL ISSUES

2.1 Recent Economic Performance.- Economic developments in Honduras during the 1980s were characterized by severe structural weaknesses in the economy that resulted in low rates of economic growth and widening financial imbalances. These weaknesses were exacerbated by a sharp deterioration in the terms of trade and the effects of political and military conflicts in the Central American region, together with the inability of successive governments to adjust domestic policies in response to the real macroeconomic deterioration.

The development strategy pursued by Honduras in the past was based on promoting industrialization through import substitution. As part of this strategy, Honduras resorted to international financing. In a short period of time, the increased use of and dependence on external resources increased the country's external debt ratio from 60 percent of GDP in 1980 to 68 percent in 1989 and to 140 percent by 1990.

As a result of the increased fiscal deficit, strong pressures were placed on the balance of payments. A current account deficit amounting to 7.3 percent of GDP was financed mainly through the accumulation of external arrears that pushed up the parallel foreign exchange rate and contributed to an increase in domestic inflation to over 10 percent in 1989 and an unprecedented 35 percent in 1990.

The effects of this strategy combined with the impact of decreasing flows of external funds, rising debt service, deteriorating terms of trade and the negative impact of regional political problems on private investment, brought about a continuing disequilibrium in public finances and a systematic reduction of the availability of resources for private investment.

By the beginning of the 1990s, the Honduran economy clearly exhibited structural weaknesses that made growth unsustainable in the longer run. Among the most serious obstacles to continued growth are a large fiscal deficit and a high level of external indebtedness -- US$ 3.3 billion as of the end of June 1990 that has converted the country into a net exporter of capital with debt service payments amounting to 30 percent of exports. In addition, there is a lack of attractive conditions to promote investment, as well as a lack of sufficient resources to finance investment, especially due to decreased domestic savings mobilization.

2.2 Current Government Fiscal Policies.- To cope with these problems, the new Honduran Government has undertaken a major adjustment program to stabilize the economy and to try to restore its external viability. To this end, the Government has enacted reform measures in the areas of exchange rate and tariff policies to try to attain sustained economic growth based on exports. In addition, a series of significant revenue enhancement measures have been enacted through which the fiscal deficit is to be brought under control. Nevertheless, the financial sector continues to be highly repressed, thereby potentially undermining the benefits that could be attained from these liberalization measures.

To this point under the new program, fiscal performance has been tightened mainly through expenditure restraint and reduced credit from the banking system to public sector. On the other hand, government revenues are lagging behind projections. Moreover, there is reason to believe that government expenditures may rise again in the near future if the fiscal improvements accomplished so far are not permanent. The current reductions in public sector investment and public sector real wages may not be sustained in the long run. As in 1990, the 1991 budget underestimates the fiscal deficit by registering debt service at the highly overvalued official exchange rate.

With the recent liberalization of the foreign exchange market, exchange rate losses associated with external debt service and the difference between the official rate (2 Lempiras per dollar) and interbank rate (5.3 Lempiras per dollar) are being assumed de facto by the Central Bank of Honduras (BCH). Exchange rate losses are being incurred mainly as a result of the imbalance between revenues from BCH rediscounts and the servicing of the foreign credit lines used to fund these rediscounts, as well as foreign loans channeled to public sector investments. Since international reserves are exhausted, the increase in exchange rate losses will put strong upward pressure on the monetary base. There is also an implication of exchange rate losses beyond their impact on the money supply as expectations may be raised that devaluation losses will be covered in the future. If private debtors believe that they will not be forced to carry exchange rate risk, foreign debt is likely to increase beyond a social optimum, including the back-to-back use of offshore funds. Under the new policy of a free foreign exchange rate, there is no justification for the BCH to continue to assume the losses to other parties resulting from their foreign exchange transactions.

The BCH has, in addition, been involved in credit expansion through increases in its other net assets that are associated with expenses not included in the official budget, mainly related to foreign exchange losses. As an example of the magnitude of these unrecorded expenses, the increase in non-classified other net assets for the period January through July 1990 was 430 millions Lempiras greater than the programmed increase of 376 million Lempiras for the entire 1990 calendar year. The lack of transparency in the fiscal accounts associated with BCH exchange rate losses and unrecorded expenses through non-classified other net assets does not allow the Government of Honduras to identify clearly and control the different forces that can create pressure for increased monetary emission.

2.3 Recent Monetary Developments and Their Relationship with Domestic Credit and International Reserves.- Monetary policy in Honduras has been greatly influenced by the financial needs of the government, BCH rediscount policies and the foreign exchange regime, as well as by changes in external prices of coffee and bananas. In addition to credit coming directly from the BCH to the government, non-remunerated reserve requirements and compulsory portfolio allocations are mechanisms designed primarily to secure subsidized financing for the government. However, these sources of finance have not been sufficient, and the government has also had to increase its external indebtedness and to resort to compulsory financing schemes such as accumulating external arrears. Recent monetary expansion has, moreover, had significant negative effects on the balance of payments and on expectations of devaluation and inflation which reduce the competitiveness of domestic financial assets. Accordingly, improvements in fiscal and monetary management are prerequisites for macroeconomic stability and the development of financial markets that could stimulate saving and investment.

The Honduran monetary base has grown steadily in real terms during the past five years. This is a positive result in that it reflects a greater demand for financial assets on the part of the public. However, it also has negative implications in that it reflects a greater participation of the BCH in financing the economy (mainly through increasing public sector foreign indebtedness) compared to the case in which the banking system increases the supply of funds for lending through increased deposit mobilization. In any event, it is much better to have an increasing real monetary base than a decreasing one -- because the latter case is likely to reflect a reflow of foreign indebtedness to international financial markets in the form of off-shore Honduran deposits, as has happened in many other Latin American countries.

Increases in the monetary base, along with financial support coming from external funds, allow the BCH to increase international reserves and domestic credit to the formal financial system and to the public sector. However, the BCH lost international reserves systematically from 1981 through 1985 (with the exception of 1983) in spite of the increase in foreign indebtedness. This implies a major increase in net foreign indebtedness (gross foreign indebtedness minus international reserves) which has gone to support public sector financing requirements and BCH rediscounts for bank lending to the private sector.

As long as the fiscal deficit is under control and increases in credit to the banking system remain low, the BCH need not lose significant amounts of international reserves. However, when international financing is stopped and the fiscal deficit and credit to the banking system increase substantially, the resulting expansion of domestic credit produces a disastrous effect on international reserves, the exchange rate and inflation. Since the public does not wish to hold the corresponding increases in the money supply, it attempts to turn Lempiras into foreign exchange through capital flight. As long as the BCH wishes to maintain the exchange rate, it is forced to sell its international reserves until they run out. When BCH international reserves are exhausted, and the monetary base increases uncontrollably to finance the fiscal deficit and to allocate more credit to the banking system during an election year, the exchange rate will ultimately collapse and inflation will soar.

As long as the foreign exchange market has not been fully unified, there will be pressure for the relatively free interbank market to depreciate the Lempira continuously as exporters retain foreign exchange (e.g., through underinvoicing of exports and overinvoicing of imports) and cause the balance of payments to deteriorate. In October 1990, the government decided to adjust the exchange rate for commercial transactions from 4.3 to 5.5 Lempiras per dollar and then to revalue to 5.4 in November and to 5.3 in December. Total unification of the foreign exchange market would ultimately be a better remedy -- under tight monetary and fiscal policy -- to allow a more stable exchange rate and lower inflation.

2.4 The Instruments and Limitations of Monetary Policy.- With the adoption of a more flexible exchange rate system by the new government, monetary policy became an indispensable tool for adequate macroeconomic performance. The monetary authorities thus need to be empowered with sufficient autonomy and monetary instruments to manage monetary aggregates effectively. Currently there are three types of limitations on the ability of the BCH to carry on an active monetary policy in Honduras:

(1) lack of political independence of the monetary authorities from the government and the private sector;

(2) inadequacy of available instruments; and

(3) inadequate organizational structure (which is discussed in the next chapter of this report).

Since the President and Vice-president of the BCH are nominated by the President of Honduras, BCH policies have to be in accordance with the government's wishes and guidelines. In particular, the BCH cannot reject a demand from the government for excess credit. An example of this has already been discussed -- monetary expansion through non-classified other net assets on the BCH's balance sheet. At the same time, banks and other private sector interests also have their representatives on the BCH board. As long as decisions on credit, exchange rate and interest rate policies are determined and conducted by such a board, it will be extremely difficult to undertake the appropriate measures necessary to attain monetary stability in a timely fashion. It is clear that conflicts of interest may often exist between the private banks and the BCH in conducting appropriate policies with respect to decisions on exchange rates, interest rates, open market operations and rediscounts. Accordingly, the basic law governing the BCH needs to be modified to make it an independent institution like the Supreme Court, without the participation of private bank representatives on its board and without its President being removed with each change in government.

The BCH is responsible for defining the guidelines for monetary policies and for their implementation through the most appropriate instruments. The basic instrument for control is the monetary program elaborated by the BCH which establishes the limits within which the BCH and the government can operate, as well as the operation of the basic policy instruments to control the money supply. In the past, public and private sector financing has not been implemented through transparent mechanisms, but instead different kind of instruments have been used, often to offset the monetary effects of credit expansion by the government to finance the fiscal deficit. Some of these mechanisms, moreover, are related to the monetary instruments. At the present time, BCH control of the money supply is based on the following instruments:

(1) reserve requirements;

(2) buying and selling of international reserves;

(3) the supply of government bonds;

(4) rediscount operations for credit to the private sector; and

(5) until recently, limits on credit expansion and interest rates ceilings.

2.41 Reserve Requirements.- Reserve requirements are an expedient way to sterilize monetary emission from different sources. However, to the extent that the BCH does not pay interest on reserves, while government bonds held in lieu of required reserves pay only 4 percent per year, these act as an implicit tax on the banking system that translates into higher spreads, i.e., lower deposit rates and higher interest rates for borrowers. In fact, reserve requirements in Honduras have traditionally been used as a system to force bank participation in financing the fiscal deficit and in providing subsidized credit to the private sector.

To increase efficiency in the Honduran financial system -- and to increase the availability of funds for private investment in particular -- the BCH will have to reduce reserve requirements or remunerate them at market rates of interest. However, paying interest on required reserves will reduce spreads at the cost of increasing the overall public sector deficit. For example, if the BCH were to pay 8.5 percent on banks' required reserves, which are approximately 10.5 percent of GDP, it would imply an increase in the fiscal deficit of 0.5 percent of GDP (83 percent of reserve are already in government bonds yielding 4 percent interest). The alternative of reducing or eliminating reserve requirements would also have an impact on the fiscal deficit since the government would have to issue bonds at market rates of interest to sterilize the resulting monetary expansion. Accordingly, fiscal adjustment and a more transparent mechanism for financing the government's deficit will be necessary before any sustainable reduction in reserve requirements would be possible. Moreover, as long as required reserves are used to finance BCH rediscounts -- either directly or indirectly (as foreign funds are used to finance rediscounts while required reserves finance the fiscal deficit) -- policy recommendations must also incorporate possible adjustments in rediscount policy into the analysis.

2.42 Buying and Selling International Reserves.- Buying and selling international reserves was the main instrument that allowed the BCH to control the money supply and inflation during the long period of stability in Honduras -- which was achieved in spite of credit expansion to the public sector and the banking system. At present, however, international reserves cannot be used to control the money supply because economic agents know that the BCH does not have enough foreign exchange reserves to control the foreign exchange market to the required extent. Until the fiscal deficit is reduced and the foreign exchange market is unified, it would be risky and naive to try to stabilize the money supply and inflation simply by selling dollars in the market -- or by not buying sufficient foreign exchange to fulfill external obligations.

2.43 Government Bond Operations.- According to the law creating the BCH, the BCH is allowed to sell government bonds and treasury bills that are already in its portfolio to the general public and commercial banks. Recently, the BCH has been trying to implement open market operations through an auction mechanism to sell short-term bonds. Although the auction mechanism is correct in theory, its implementation in practice has proved to be inadequate, as very few bids were submitted to the BCH by banks or the general public at several recent auctions.

Various reasons can be given to explain the failure, so far, of the BCH's auction system. Open market operations implemented through an auction system -- which can be an excellent instrument to regulate the money supply through buying and selling bonds or bills to commercial banks and the general public -- require that either the amount or the interest rate be free to vary. In the case of Honduras, the BCH has been trying to fix the price -- the interest rate -- and the quantity to be sold at the same time. In addition, currently existing government bonds can be redeemed on demand and their interest is tax free, so that the government must expect to pay higher interest rates on the new bonds to be used in the auction system. To have successful auctions in the future, the BCH will need to auction bonds without fixing in advance either the interest rate or the amount to be sold. Nonetheless, an auction can the best mechanism to choose the interest rate and the amount of bonds to sell, once the information is known with respect to the bids submitted by the public in general and the banks.

2.44 Rediscount Policy.- The main BCH rediscounts are to commercial banks for loans to specific priority sectors selected by the government on the basis of income distribution and resource allocation objectives (e.g., farmers, small and medium firms, exporters, construction activities). Rediscounts constitute a powerful monetary instrument, especially in that they represent almost 50 percent of net domestic credit on the BCH's balance sheet. When rediscounts are given to any financial institution, monetary expansion results, whereas monetary contraction occurs when rediscounts are canceled. As long as the BCH does not have at its disposal adequate market instruments -- such as effective open market operations -- for controlling the money supply, the seasonal pattern of rediscounts constitutes a severe restriction for attaining monetary stability within the year. In addition, there are problems with the BCH's management of rediscount lines as interest rates are currently set far below inflation so that rediscount policy must be implemented through non-price rationing mechanisms. Banks' effort at resource mobilization are also discouraged because banks have access to cheaper funds from the BCH.

In the case of external funds, there are a large number of different rediscount lines based on funds lent or granted to the government by various donor agencies and put at the disposition of the BCH. The wide range of interest rates (from 9 percent to 17 percent depending on the particular source of funds) and other conditions associated with these different rediscount lines make them very difficult for the BCH to administer. Moreover, external rediscount funds are on-lent in Lempiras, so that the BCH assumes the exchange rate risk. To the extent that rediscount rates are not at market levels, the BCH is not properly covering itself against this risk, and, in addition, several external rediscount lines have shrunk in real terms with the recent devaluations.

In the case of Honduras, there is evidence that preferential low interest rates on rediscounts have not improved income distribution. With respect to resource allocation, all that is changed is one component of the price of capital -- which is reduced only for those individuals with access to credit at preferential rates. In addition, low interest rediscounts induce credit deviation since, instead of using their own capital, individuals with access to cheap credit will prefer to leave their funds untouched -- perhaps outside of Honduras -- and to ask for rediscounts. In fact, as long as the BCH offers rediscounts at 15 percent and supplies bonds at 19 percent, it induces deviation by providing a significant spread without risk and with the only effort required to ask for money at one window and to buy bonds at the other. Also, with preferential interest rates below the rate of inflation, unprofitable projects can be implemented that will have no net positive effect on aggregate output. Moreover, low interest rediscounts have to be rationed, and the rent seeking that invariably accompanies subsidies reduces welfare and tends to corrupt the system. Although financial intermediaries appear to take the credit risk in rediscount operations -- the BCH charges their respective reserve accounts when rediscounts mature -- as long as the banks have easy access to liquidity rediscounts, the BCH may in the end be refinancing bad portfolios.

According to these considerations, it would be advantageous to move away from subsidized rediscount lines for priority activities -- and borrowers -- and toward a system that utilizes price rationing mechanisms. However, such a major change in rediscount policies constitutes a structural change for Honduras because rediscounts are related to and integrated with other policies such as reserve requirement policy, exchange rate policy and interest rate policy. For this reason, the discussion of possible changes in rediscount strategy will be left for the end of this chapter, after interest rate policy has been analyzed.

2.45 Interest Rate Policy.- Until recently, the BCH has fixed the maximum interest rate on bank loans. Although interest rates on deposits have been free from direct control, ceilings on loan rates indirectly impose limits on these as well. Interest rate ceilings discourage financial intermediation through formal markets because regulated intermediaries are less able to compete with unregulated informal lenders, especially in more risky and costly operations such as lending to agriculture and to smaller manufacturing and service enterprises. Interest rate ceilings also undermine deposit mobilization and thereby limit further the capacity of the banking system. In addition, interest rate controls stimulate the formation of economic groups, with resulting loan portfolio concentration. Controls over interest rates also have fiscal aspects. The issuance of tax free government bonds redeemable on demand with yields similar to the rates that can be paid on bank deposits places the government in a favorable position to capture a significant part of the transfer of income from depositors to users of credit.

Controlling the rediscount rate has been an effective instrument of monetary control and a useful market signal in most developed countries. In order to be a useful instrument for monetary policy, the rediscount rate should reflect banks' marginal cost of mobilizing funds and the degree of tightness that the monetary authorities wish to impose on the economy. At the same time, bank spreads should be free to be determined by market competition. Recently, the BCH has partially liberalized interest rates for new loans made by banks with their own funds, subject to the conditions that a bank's "basic interest rate" has to be announced to the Superintendency of Banks one week in advance, has to be the same on all loans, and cannot be changed for at least one month -- an approach which does not allow differentiation among borrowers by risk and cost and which may also contribute to collusion among banks in setting rates. In addition, the basic rediscount rate has been left unchanged at 15 percent -- well below the inflation rate for 1990 of 35 percent and also below the rate on government bonds. This is not a sound interest rate policy.

2.5 Savings Mobilization.- Savings mobilization has been poor in Honduras compared to most other developing countries, including especially other countries in the region such as Costa Rica. This is true for both concepts -- saving as the portion of income not consumed and savings as the accumulation of stocks of financial assets. With respect to this first concept, national saving declined steadily from 15 percent of GDP at the end of the 1970s to 3.6 percent in 1989, due in part to the simultaneous negative effects of a deterioration in the terms of trade and increased foreign factor payments, especially in the form of interest, that reduced national saving capacity sharply.

For many years foreign savings compensated for the shortfall in national saving and provided the necessary resources for investment -- and to some extent foreign savings may even have crowded out domestic saving. As long as foreigners were willing to finance higher expenditures in Honduras, residents were able to spent more and consequently saved less. However, because of the debt crisis, the availability of external funds has been greatly curtailed, remaining stagnate at about 5 percent of GDP. In addition, many years of overvaluation of the real exchange rate stimulated consumption by making tradable goods less expensive and thereby also discouraged saving.

With respect to the second concept of savings, currency and bank deposits have remained stagnate at about 35 percent of GDP in recent years. Since these are the main sources of funds for credit expansion by the financial system, the system has not increased its capacity to expand credit to the private sector. In addition, the declining share of time and savings deposits and the increasing share of currency and demand deposits are symptoms of greater liquidity preference by the public -- perhaps related to increasing development of the informal financial system. Savings performance could be improved through increased mobilization by the formal financial system, but this requires the ability to stimulate higher demand for financial assets.

While many factors can affect the demand for financial assets, the main determinants in the case of Honduras are -- according to the econometric estimates for this study -- substitution among Lempiras, dollars and goods, together with income changes. The long run elasticity of money demand with respect to inflationary expectations is extremely high, reflecting a strong substitution between money and goods. This effect explains the stagnation in the demand for financial assets as the Honduran economy became more inflationary with the financing of the increased fiscal deficit. Substitution between dollars and Lempiras is reflected in the strong negative effect on the demand for financial assets of the rate of acceleration of the real appreciation of the Lempira.

The demand for money, and time deposits in particular, is strongly influenced by real interest rates, as indicated by the significance of expected inflation, but is not affected by nominal interest rates on Lempiras deposits. The effect of the level of transactions -- with an income elasticity equal to 1.0 as theory predicts -- also helps to explain the stagnation of money demand in real terms during the past two years, as the economy substantially reduced its rate of growth.

2.6 Main Conclusions and General Recommendations.- A declining demand for money and poor savings mobilization in general have three major implications:

> First, if savings performance does not improve in the future, the banking system will become increasingly constrained in its ability to finance investment.
>
> Second, the use of external funds to expand credit to the private sector will be offset as the BCH will lose international reserves, and ultimately domestic inflation will be pushed up if the demand for financial assets does not recover.
>
> Third, policies that rely on subsidized credit are in conflict with the promotion of saving since low interest rates on rediscounts will discourage deposit mobilization.

The main recommendation for improving policies to promote mobilization and efficient allocation of saving is to focus on promoting a recovery in the demand for domestic financial assets through the pursuit of realistic interest rate policies in the context of liberalized financial markets.

Adjustments in interest rate policies should allow interest rates on both the assets and liabilities of the domestic banking system to reflect market conditions, either by liberalizing controlled interest rates completely or by gradually phasing out such controls. Interest rate policy reforms and financial reforms -- mainly eliminating subsidized and targeted rediscounts, reducing reserve requirements, introducing market oriented monetary policy instruments and restructuring the BCH to allow greater independence -- are intended not just to raise the overall level of private saving but also to influence its composition through channeling savings away from other destinations (such as capital flight into foreign financial markets or informal markets) and toward the domestic banking system, through which it can be more efficiently allocated to domestic investments.

Capital flight, reflected in the stagnation in the demand for domestic financial assets, is a major issue in view of the present heavily indebted condition of the public sector in Honduras. A solution to this requires that domestic savers find the holding of domestic assets -- both financial and physical -- to be profitable. Unless investment in physical capital at home is profitable, even a well-functioning financial system would tend to place accumulated domestic savings abroad. If opportunities for domestic investment exist, financial repression (e.g., not unifying the foreign exchange market or penalizing dollar denominated assets with excessive reserve requirements) will tend to induce accumulated domestic savings to move abroad. In the presence of such capital outflows, domestic investment opportunities will go unexploited unless foreign financial intermediaries are willing to lend to domestic firms. Financial reform measures can obviate the need for this external financial intermediation by changing the composition of national saving away from the accumulation of foreign financial assets toward the accumulation of domestic assets.

The monetary policy instruments employed by the BCH do not allow the necessary transparency for the proper functioning of the financial system or for monetary stability. One necessary condition for monetary stability is the independence of the BCH from the direct influence of both the government and narrowly defined private sector interests. Moreover, with the current fiscal deficit, the banking system has become a large net lender to the public sector through reserve requirements and related holdings of low-interest government bonds, and this needs to be changed in the future. As part of a more liberalized financial framework for the future, reserve requirements should be reduced and remunerated at market rates of interest -- and even ultimately eliminated -- but with the present macroeconomic imbalances, this cannot be recommended until the fiscal deficit has been brought under control.

Under the current fiscal constraint, a second best alternative would be to reduce reserve requirements gradually and simultaneously reduce BCH rediscounts. Given the current levels of rediscounts, required reserves and related holdings of government bonds, it should be possible to eliminate rediscounts financed with the BCH's own resources simultaneously with the elimination of reserve requirement and forced holdings of government bonds. This would have a neutral monetary impact in the aggregate -- but would, of course, present severe problems for those banks that have relied heavily on BCH rediscounts as compared to those that have mobilized their own deposits successfully. At the same time as reserve requirements and rediscounts are reformed, the BCH could begin selling public debt through open market operations.

The administration of rediscounts financed with foreign resources needs to be reorganized. Since subsidized credit has been rationed by non-price mechanisms -- because demand is always greater than supply -- BCH rediscounts have been allocated inefficiently. Accordingly, it would be useful to examine the possibility of implementing an auction system for rediscounts, as is under consideration or already implemented in other Latin American countries (e.g., Jamaica, Chile and Bolivia). In the case of an auction system, investment projects compete for funds based on their respective rates of return and not according to arbitrary administrative practices. In addition, the rediscount rate determined in the auction can be related to other interest rates in the market that have already been liberalized. To implement an auction system would require a detailed analysis of the conditionality of existing foreign credit lines. With respect to the current system, rediscount rates should be equalized at a rate at least equal to the marginal cost of funds for the banks, that is, the maximum of the highest deposit rate (adjusted for reserve requirements) and the rate determined in the bond auction that would be used to carry out the open market operation of the BCH.

In a liberalized framework, the BCH could employ appropriate market-oriented monetary instruments to hold credit expansion under control, such as open market operations to sterilize an excess supply of funds. The demand for credit would automatically be restrained by the prevailing new interest rate structure that would be higher than inflation, as well as more flexible. The BCH can nonetheless continue to control interest rates by managing the open market auction appropriately.

Whenever the fiscal deficit is high, interest rates will rise, fewer projects will be profitable and the demand for credit -- including the demand for credit to speculate with foreign exchange -- will be reduced. When the fiscal deficit begins to be reduced, interest rates will decline and credit to the private sector will recover again. In addition, the interest rate determined by open market operations should be arbitraged with foreign rates through the expected rate of devaluation.

Through open market operations, the BCH can hold the money supply under control, and the financing of the fiscal deficit will become more transparent. The cost of deficit financing will become larger, so that government expenditures will increase, but the benefits from increasing the credit capacity and lowering the spreads of the banking system will stimulate financial intermediation and economic activity.

2.7 Specific Recommendations for Macrofinancial Policy Reforms.-

- o Reduce the public sector fiscal deficit such that it can be financed through transparent, market-oriented means that do not crowd out the private sector and consequently undermine investment.
- o Unify the foreign exchange market by eliminating exchange controls that require exporters to surrender their foreign exchange to the BCH and importers to access foreign exchange through the BCH.
- o Attempt to assure greater independence for the BCH and allow it to use monetary instruments for monetary control rather than for financing the public sector fiscal deficit and channeling funds at below market interest rates to the private sector.
- o Improve the technical capabilities of the BCH to use the main instruments of monetary control, that is, open market operations, reserve requirements and rediscounts.
- o To the extent that interest rate controls are not completely phased out, tie them to a market rate of interest such as that determined in the auction market for government bonds where the BCH would carry out its open market operations.
- o As a first step, undertake:
    - o a parallel reduction in reserve requirement and rediscounts;
    - o a movement of the rediscount rate to market levels;
    - o the remuneration of remaining required reserves at market rates; and
    - o the initiation of open market operations through an auction system.

3.0 CENTRAL BANK OPERATIONS

3.1 Background.- The Central Bank of Honduras (BCH) does not currently have an organizational structure that is appropriate for a modern central bank. This inadequacy could become a serious impediment to carrying out the functions that are required of a central bank under the type of liberalized financial environment that Honduras hopes to achieve. In part, the BCH suffers from inefficient organizational arrangements with respect to the roles that it is expected to play, but more importantly it has been delegated a number of responsibilities that are inappropriate for a central bank and that often interfere with its basic role. For example, it has responsibility for the approval of import quotas and permits, and it carries out certain commercial banking functions, as well as a variety of non-banking activities, for the Honduran Government. The following discussion focuses on the principle problems that inhibit the BCH in carrying out its current functions and especially on those that could become more important as financial liberalization proceeds.

3.2 The Relationship of the BCH with the Honduran Government.- The BCH currently lacks sufficient independence from the Government. On one hand, the BCH is excessively involved with aspects of the Government's economic policy that are too far removed from an appropriately narrow focus on monetary and financial policies. On the other hand, it does not have sufficient autonomy in monetary and financial policies as reflected in the fact that its Board of Directors is dominated by representatives of the Government who can readily be changed. At the same time, the private sector members of the BCH's Board of Directors are seen to represent narrow commercial banking interests rather than the country's economic welfare in general. While it is useful to have some members of the BCH's Board of Directors who have had first-hand operating experience with private-sector financial institutions, in addition to those who have expertise in monetary and financial policies, it is difficult to see how conflicts of interest can be avoided for members who are simultaneously directly involved with private banks.

Although the BCH clearly cannot be totally independent from the Government and its economic policies, it does require greater autonomy in order to carry out its essential functions of regulating the supply of money and credit, maintaining the foreign exchange regime and supervising the financial system. Such autonomy could be promoted and possibilities for political intrusions reduced if, for example, members of the BCH's Board of Directors did not serve "ex officio," were appointed for fixed terms and could only be removed for "cause" (e.g., evidence of corruption). To implement these changes will require a careful review and modification of Honduran banking laws to grant greater independence to the BCH, not only from the Government but also from narrowly defined private sector interests. At the same time, these laws should orient the BCH clearly toward its main functions of safeguarding the currency and maintaining both domestic and foreign payments. Moreover, new laws will only be effective if they are written so that decisions made by the BCH can be viewed as credible and respected, with the BCH clearly defined as the key institution in regulating the financial system.

3.3 Credit Policies.- Credit policies of the BCH need to be adapted to conform more closely to objectives and responsibilities that are consistent with increasing financial liberalization. In particular, the BCH should adopt policies that tend to reduce the dependence of commercial banks on BCH rediscounts and that encourage greater savings mobilization from the private sector. The BCH should nonetheless continue to play a role in channeling long term credit for development from the funds provided by international donor agencies. Among the major changes required are:

- o Short term lending by the BCH should be ended except for managing liquidity in the financial system.

- o Long term development credit should be centralized in the BCH's Department of Credit in order to unify the terms and conditions of different credit lines and to provide the information necessary to manage these lines effectively.

- o Operations of the BCH's Department of Credit should be simplified, and financial intermediaries should be fully in charge of dealing with the ultimate borrowers.

- o Present credit regulations should be modified so that credit terms and conditions can be made uniform for funds from different international donor agencies. As part of this, the BCH should be free to set interest rates for intermediaries and for ultimate borrowers at rates that fully cover the marginal cost of acquiring funds -- including foreign exchange risk which currently is often not covered adequately.

- o Financial intermediaries should assume all the credit risk and should thus assume sole responsibility for project evaluation. The BCH should only conduct selective ex-post evaluations which would be based on an efficient sampling procedure and would possibly be contracted to external auditors. Ex-ante evaluations by the BCH would be terminated -- which could greatly reduce transaction costs for the BCH, the intermediaries and the borrowers.

- o The BCH should consider using an auction system for the allocation of funds for its long term development credits.

- o To reduce the risks of excessive re-financing by the BCH, especially for banks with high proportions of problem loans, interest rates on short term funds from the BCH should be high relative to market rates.

3.4 The BCH as Fiscal Agent and Banker for the Government.- The BCH has taken on various functions that extend far beyond the normal role of a central bank. In fact, the BCH has to maintain several regional branches in order to carry out functions such as check clearing, loan processing, tax collections and the payment of government salaries. Loan processing could be simplified, as explained above, and the other functions should be transferred either to private sector entities (e.g., commercial banks) or to other government agencies. This could result in the elimination of most or all of the regional branches, which would not only increase the BCH's efficiency and reduce costs but would also allow the BCH to focus more effectively on its essential tasks. In addition, the function of actually printing money should clearly be taken out of the hands of the BCH.

3.5 Excessive Centralization, Lack of Coordination, and Inadequate Systems of Internal Control.- The BCH is excessively centralized -- for example, by law the general manager is directly in charge of virtually all BCH operations without any legal power to delegate -- but at the same time lacks adequate systems of information, coordination and control. Lack of adequate internal controls is especially problematic and could lead to substantial loses for the BCH.

A major reorganization plan has been proposed that would restructure the BCH in two phases. The first phase would focus on decentralizing the BCH to improve its ability to carry out its current functions, while the second phase would involve a redefinition of some of the tasks and responsibilities assigned to the BCH. Although this plan provides many useful suggestions for improving the operations of the BCH, it runs a high risk of not being fully implemented -- once the BCH has been restructured to carry out its current functions, it could be very difficult to restructure it a second time to carry out a redefined set of tasks and responsibilities.

Although it is recommended to reverse the proposed two phases in reorganizing the BCH, the problem of inadequate internal controls should be treated immediately, and the subsequent implementation of an integrated accounting system leading to an integrated financial system should be given very high priority. In addition, many of the changes in the basic tasks and responsibilities of the BCH that are recommended in this report go well beyond the mandate of the proposed reorganization plan. Nonetheless, the proposed plan provides many useful suggestions and an excellent starting point for creating a new BCH that has the highly flexible structure and the highly trained staff necessary to focus on the crucial areas of monetary management that are essential for continuing successful financial liberalization.

3.6 The Role of the BCH's Department of Economic Studies.- The BCH needs to establish a more efficient information system in order to make correct and timely decisions to carry out monetary and financial sector policies more effectively. Time lags are currently too great not only in receiving information from financial institutions but also in processing and analyzing this information in a manner that is most useful for policy decisions.

In addition to receiving daily and weekly reports from financial institutions with respect to crucial monetary and financial variables, the BCH needs to reorganize the handling of this information. On one hand, there should be a unit of high level technicians in the Department of Economic Studies to analyze this information on a daily basis and report any significant changes to the highest levels in the BCH. On the other hand, there should be also be a unit of high level technicians in the Department of Economic Studies to take charge of developing and monitoring a monetary program that includes inter-relationships with the fiscal situation, the exchange rate and the balance of payments, the rate of inflation and the level of real economic activity, etc., as well as the key monetary variables themselves. This second unit, or possibly another separate unit, should have responsibility for undertaking analytical studies of the monetary and financial system, including such issues as the soundness and competitiveness of the institutions that comprise the system.

The BCH also needs to enhance its human capital to provide the high level technicians that are necessary for optimal policy decision to be made. Strengthening the Department of Economic Studies will thus entail significant amounts of training and technical assistance. Training could involve some graduate level training at foreign universities, but particular emphasis should be placed on short-term (i.e., one or two months) specialized training that focuses on the main issues facing financial sector policy makers in developing countries. Training should also include seminars that bring high level foreign experts to Honduras who can at the same time be involved in providing technical assistance in the formulation of a monetary program and in dealing with other crucial issues facing the BCH and its Department of Economic Studies.

3.7 Specific Recommendations for BCH Operational Reforms.-

- o The focus of the BCH should be narrowed so that it is clearly responsible for monetary and financial sector policies and their implementation and not for a boarder range of economic or governmental activities.

- o The BCH should have adequate autonomy and independence which will require modification of pertinent laws, including those covering the selection of members for its Board of Directors.

- The plan to reorganize and decentralize the BCH should be implemented, with some modifications, but only after the essential functions of the BCH have been clearly defined -- except that immediate attention should be given to improving internal controls and to developing an integrated accounting system for management information and financial control.

- The BCH should reform its rediscount policies so that short term credits are granted to banks only for liquidity management purposes and so that procedures for granting long term credits for development purposes are reformed. In both case, interest rates on rediscounts should be high enough to cover the costs of funds (including any foreign exchange risk) and not to discourage deposit mobilization by banks.

- The BCH should be assisted in obtaining training and technical assistance in a variety of areas, but especially with respect to the following:

    - for the Department of Economic Studies so that it can play its essential role in developing the BCH's monetary program and in providing crucial information and analysis to highest level BCH management;

    - for the Department of Credit to develop new approaches to handling rediscounts and for the initiation of open market operations; and

    - for improving internal controls and developing an integrated financial system for management information and control.

4.0 FINANCIAL INSTITUTIONS

4.1 The Commercial Banks

4.11 Background.- There are fourteen commercial banks in Honduras. They represent about 92% of the total private, formal financial institution assets (private commercial banks and S&L's). Several of these financial institutions are affiliated with other commercial banks (or groups owning other commercial banks) and with savings and loan associations and insurance companies. Two of the fourteen banks are branches or subsidiaries of foreign banks and operate under the policies and standards of their parent companies. The following table summarizes the relative size of the banks in Honduras:

TOTAL ASSETS AND DEPOSITS OF COMMERCIAL BANKS
JULY 31, 1990
(figures in millions of Lempiras)

Institution	Assets	% Share	Deposits	% Share
Atlántida	867	18.8%	615	20.4%
Honduras	146	3.2%	111	3.7%
Occidente	461	10.0%	325	10.8%
Londres	154	3.3%	78	2.6%
Ahorro	349	7.6%	274	9.1%
Trabajadores	283	6.1%	176	5.8%
BANCAHSA	540	11.7%	362	12.0%
Comercio	208	4.5%	83	2.8%
Continental	251	5.4%	101	3.3%
FICENSA	205	4.4%	146	4.8%
SOGERIN	361	7.8%	210	7.0%
BANFFAA	316	6.8%	261	8.7%
Mercantil	244	5.3%	155	5.1%
BANCAFE	233	5.0%	118	3.9%
TOTAL:	4618	100.0%	3015	100.0%

It is interesting to note that Banco de Honduras (a 100% owned Citibank subsidiary) and Banco de Londres (a branch operation of Lloyd's Bank), represent the banks with the smallest asset bases in the country.

Banco EL Ahorro Hondureño and BANCAHSA are controlled by the Smith family, a wealthy Honduran group long involved in banking, insurance and coffee. In addition to the two banks, which have captured 21.1 % of the deposits of the system, the group controls two Savings and Loan Associations and an insurance company.

The largest bank, Banco Atlántida, a former affiliate of Chase Manhattan Bank, controls a Savings and Loan Association and an Insurance company.

Banco Continental, is headquartered in San Pedro Sula and represents the financial hub of Jaime Rosenthal's Group. This group has interests in Banco Occidente and controls a savings and loan association.

The bureaucratic requirements for obtaining new banking licenses in Honduras are viewed as relatively cumbersome. As a result, in recent years, investors have preferred to seek charters by finding a specific niche or constituency which would provide the appropriate justification for creation of a bank through the legislative action of Congress. Thus, BANFFAA (the Armed Forces Bank, Banco de los Trabajadores, and most recently, BANCAFE were created to serve specific markets. While the government has, in certain cases, retained a minimal ownership interest in these banks, over time they have evolved into general service commercial banks with little, or no, management interference by the government. As an example, BANFFAA is owned by the armed forces pension fund and certain retired military officers. BANCAFE is owned by over 45,000 shareholders engaged in various aspects of the coffee industry.

4.12 Financial Condition.- When taken at face value, the financial information on the banking system, which is collected and maintained by the Superintendency, supports the opinion of Superintendency personnel and private sector commercial bankers that most of the commercial banks are financially sound. It is important to note, however, that a thorough review of each bank's loan portfolio has not yet been carried out. A reclassification of bank assets resulting from such credit reviews would probably effect profound changes to the financial statements of the banks and could therefore cast doubt as to the solvency, and profitability of the system.

An analysis of the financial statements in the system (ratio analyses were performed as part of the preparation of the technical reports submitted in conjunction with this central report) reveals that several of the banks may have portfolio problems that are not clearly evident from a cursory review of financial statements generally made available to the public. It was possible to identify those institutions with significant capital adequacy problems by comparing their level of capitalization plus allowances for loan losses to their level of past due loans, matured loans, real estate taken in lieu of foreclosure and loans financing the sale of real estate taken in lieu of foreclosure. A careful review of these figures indicates that at least half of the banks, including some of the larger ones, appear to have capital adequacy shortcomings. In anticipation that careful credit review and the resulting charges to net worth, would, in fact, impact severely on the capital of many of the banks it can be concluded that there appears to be a generalized lack of capitalization in the system.

Through the interview process with the banking community and with the Superintendency staff it was possible to determine quite conclusively that at least three banks are clearly recognized to have serious financial difficulties requiring close monitoring by the Superintendency. These banks find themselves in distinctly difficult financial circumstances and have been under special Superintendency attention, referred to as "supervisión preventiva" - a very mild form of intervention. This has apparently served to get one bank "back on track" but is probably postponing the inevitable demise (liquidation or sale) of the other two.

Thus, there is no doubt whatsoever that the three weakest banks need additional capital. If new capitalization were not forthcoming there would also exist the alternative that these banks be liquidated and their good assets and premises be sold to healthy institutions. However, the

Superintendency of Banks and the Central Bank are inexperienced in the intervention and liquidation of financial institutions and appear to have been reluctant to force the issue thus far. The only other case of government action to reorganize or shut down a bank in recent history was the liquidation of Banco Financiera Hondureña during the late 70's. This problem will be addressed further in Chapter 7.

4.13 A. Financial Information Disclosure.- Honduran banks are not required to publish financial statements with any meaningful information for the public or to shareholders. However, detailed and/or high quality information exists. Obtaining it is the problem. The disclosure of information to the public should become a legal requirement in Honduras.

The nature of information that exists is as follows:

- Banks - Direct Information. Most financial institutions disseminate only minimal information to the public but will generally provide independently audited financial statements to certain others such as correspondent banks (who require financial statements in order to grant credit facilities to the banks). A few publish annual reports which contain financial information with some detail. However, they typically do not disclose the kind of information which would enable the reader to determine the condition of the loan portfolio, the quality of the bank's assets the adequacy of allowances for loan, and other, losses or the extent of insider lending.

- Banking Superintendency. Each financial institution must submit a monthly "balance analítico" (detailed balance sheet and income statement) to the Superintendency. These contain much useful information, although the information is presented in an arcane manner that does not allow for easy or reliable analysis of loan portfolio problems. No detail is made public - even to the banking system - due to a very broad interpretation of the "bank secrecy" laws.

  Some of the most serious shortcomings of these reports include the lack of clear guidelines as to how to present detail on past due and matured loans, the lack of any detail as to insider lending, the lack of detail regarding loans that have been discounted under various rediscount programs, and the lack of a breakdown and detail as to foreclosed property and projects under development. These are only a few examples; numerous others exist.

- Public Accountants. As mentioned earlier, their reports are reliable - if one can obtain them.

Theoretically, banks and savings & loan associations are supposed to require audited financial statements from any borrower that owes the institution more than L.150,000 (about U.S.$30,000 at the prevailing rate of exchange). However, this is not common in practice. Honduran financial institution lending still tends to be based more on real estate collateral and the reputation of the borrower than on financial/cash flow analysis. The Superintendency needs to enforce the practice of requiring that appropriate financial information be placed in bank credit files through the audit of each bank's **credit process** management.

4.14 Public Accounting Firms.- At least two major international accounting firms, KPMG Peat Marwick and Price Waterhouse (represented locally by R. Rodriguez y Asociados), have offices in Honduras and have financial institutions among their local client base. Peat Marwick dominates the financial institutions market, counting approximately ten of the fourteen banks and five of the six savings & loan associations among their clients. Price Waterhouse reportedly has two commercial banks and the Banco Nacional de Desarrollo Agrícola as clients. A local firm, Morales, Palacios y Williams, has one commercial bank.

Generally, the international accounting firms appear to apply the same rigorous and high quality professional bank audit standards as would be applied anywhere else. Generally, the international accounting firms apply the same, high, audit standards, as published in their head office audit procedures manuals. A reading of several sets of audited financial statements together with accompanying footnotes evidenced the detail and quality that one would expect of firms of the stature of KPMG Peat Marwick and Price Waterhouse. In particular, there was appropriate comment with respect to the loan portfolios, allowances for loan losses, insider lending, and other sensitive matters.

Most audited statements for banks in Honduras bear qualified opinions due to inadequate loan loss reserves, improperly accrued interest on delinquent loans, and worthless contributions to CONADI. Ordinarily, in industrialized countries, this would be viewed as a serious blemish on a bank's reputation. However, since the audits are not made available to the public and they are only seen by the bank's stockholders and the Superintendency, no-one seems particularly concerned that bank financial statements may be qualified.

The CONADI matter bears further comment. According to a law passed some years ago (around 1975), banks and insurance companies (but not savings & loan associations) had to contribute ten percent of their capital and accumulated reserves as of December 31, 1973 as an investment in the equity of Corporación Nacional de Inversiones - CONADI (an autonomous institution of the Honduran Government). These contributions were adjusted annually based on the net worth of each contributing institution. The contributions were documented with non-negotiable certificates, without specific term, and bearing interest at the annual rate of 6%. CONADI has incurred substantial losses in recent years and is currently in liquidation. It is unlikely that the financial institutions who were forced to make this investment will ever recover anything. On May 4, 1989, the Government of Honduras authorized banks and insurance companies to discontinue the annual contributions established in the original law. However, it did not establish policy with respect to how banks and insurance companies should treat contributions already made. Individually and in the aggregate, these contributions are rather significant (ten percent of capital).

One item that is highly desirable but that was not observed in the materials reviewed was evidence of a rigorous credit review wherein an appropriately designed sample of the institution's loan portfolio is examined and classified by standards used in the U.S. and many other countries (to include countries in South America). Typically, the public accounting firms would have to conduct some examination and analysis of the loan portfolios in order to express opinions with respect to the financial statements. However, a thorough credit review goes well beyond this. Credit reviews are best conducted by persons with significant bank lending, credit administration and remedial management experience. Such a credit review would be highly desirable for commercial banks (other than perhaps Banco de Honduras which would be adequately reviewed by Citibank staff and Banco de Londres which would be reviewed by Lloyd's Bank International staff) and for those savings & loan associations which are heavily involved in lending other than the traditional loans to finance housing and secured by mortgages.

4.15 The Impact of the Pension Funds.- As discussed in the macrofinancial sector of this report, inasmuch as interest rates are below current, and expected, inflation rates, there is little, or no, incentive to save in local currency instruments. However, there are four large pension funds in Honduras which must invest their resources locally. Since participation in these pension funds is mandatory for employees of the sectors served by those funds, there is a large and rapidly growing pool of funds which must be invested. Regulations and available alternatives limit investment opportunities for the pension funds, and, as a result, the pension funds are an important source of savings and liquidity for the banking system in Honduras. (This is especially true for the savings & loan associations and at least one commercial bank, Banco de Las Fuerzas Armadas (BANFFAA), which automatically receives the bulk of investible funds from the military pension fund.)

As will be discussed at greater length later in Chapters V and VI, there has not developed in Honduras a market for medium and long term investments in financial assets. Consequently, pension fund assets, which are invested in the banking system, are invested on a short term basis. This has resulted in a significant pool of resources which is being increasingly viewed by some bankers with alarm because of its potential volatility. As will be pointed out later it is important that policy modifications be implemented to stimulate the creation of a **market determined** financial index which would permit essentially medium to long term investors, such as pension funds, to commit funds, at longer maturities, in return for increased yield which would be equitably adjusted periodically in accordance with the movements in financial markets.

For the time being, the large pension funds will continue to be a major source of new money for many financial institutions. Eventually, however, these resources will decline, probably resulting in an outflow of funds as pension beneficiaries reach retirement age and begin to draw on their benefits.

Notwithstanding the tremendous source of savings and on-going liquidity represented by the pension funds, the long-term implications of inflation and eventual benefit payment obligations of those funds are extremely perilous. If interest rates continue to be controlled and maintained at levels that constitute negative real rates of return, then the financial system will have few sources of new savings.

4.16 Competition.- There are very few new customers in the system. Therefore, growth has come from moving customers from their current banks. Growth in loan portfolios is deceptive since inflation causes existing borrowers to need, and gradually obtain, increasing amounts of credit. Competitive advantage derives, in some cases, from well-capitalized banks having larger lending limits and the ability to make more and/or larger loans to large or growing companies.

As mentioned earlier, because banks have little incentive to compete by offering services at lower prices, competition generally takes the form of trying to offer, or claiming to offer, better services. Some banks will accommodate their special clients by entering into directed foreign exchange transactions, whereby an exporter will sell dollars to a bank under the condition that the bank sell the dollars to a specific party, who in turn pays the exporter a premium. This demonstrates the distortions caused by exchange rate controls.

Under a repressed financial system, where all pricing policy is set by Central Bank regulation, governments inadvertently provide potential cartels with the mechanisms to police such a cartel. By establishing maximum interest rates, commissions, and all manner of service fees the regulators enter into a tug of war with the cartel participants whereby the pricing structure is eventually established at a level where all of the cartel participants are content and the regulators can claim that the cartel participants are being prevented from enjoying excessive profits. In reality, what occurs is that the "maximum prices" set by the regulators become an established guideline with which the cartel participants can easily police their membership's pricing behavior.

Typically, regulators will meet periodically with the "association" representing the cartel in order to discuss the potential impact of new legislation, or regulations. Supposedly, regulators do this in order to facilitate the communication process with those being regulated. In fact, what occurs though this communication mechanism is the enhancement of the "association's" legitimacy. The process becomes, in fact, a bargaining session. Thus, the "association" is able to develop some policymaking leverage that it perhaps should not be entitled to.

As a result of the above, what develops is a marginal revenue pricing scheme legitimized through the negotiating process between regulator and regulated, rather than the lower marginal cost pricing scheme resulting from natural competition. This occurs often with regulated industries. A notable example was the airline industry in the United States. As soon as regulation was ended the competitive process brought prices to the consumer down.

The behavior of the Central Bank and of the Bankers Association in Honduras offers an interesting parallel. Without the benefit of an inductive study of the financial system's pricing experiences (for deposits as well as loans) over the years it is not possible to ascertain this thesis at this time. Nevertheless, there is a certain level of comfort observed in the relationships established between the bank regulators in Honduras and the bankers' association which supports the thesis.

4.17 Entry Requirements for New Banks.- There are four bank charter applications pending. Several bankers expressed serious reservations about at least two groups seeking charters, notably one made up of a group that includes two ex-bankers that were allegedly largely responsible for their prior institutions' current or recent insolvent status.

Approval of these institutions, given the circumstances surrounding the alleged misdeeds of the promoters, would have to be demoralizing for the Superintendency and for the Central Bank and it would clearly demonstrate the lack of power of these institutions to police the financial sector. Because financial institutions are granted the right to accept **and safeguard** the public's deposits, a clear acknowledgement of public trust, only the perfectly untarnished should be granted this trust. The proper screening of bank applicants is of very serious concern to local bankers and to the public. Policymakers should take note.

4.18 Recommendations.-

4.181 Training needs.- There are serious threats to the financial system as a whole. Many of the Honduran bankers appear to be fully aware of the dangers but are apprehensive about the financial liberalization process which appears to be inevitable. Most banks are ill-prepared to deal with funds management, treasury and foreign exchange trading requirements and opportunities which will result from financial liberalization. Liberalization, if properly implemented, will raise the level of competition in the financial system thereby strengthening efficient institutions and weakening those who fail to adapt to the new order. Under this scenario there will be many opportunities for intervention by USAID and the multilateral agencies to provide technical assistance and training. Of particular interest to the banks will be support in the areas of liability management and the development of effective controls for participation in newly activated money and capital markets. Additionally the banks are in need of assistance in the area of asset/liability management and other treasury related functions.

Inflation, bad loan portfolios, and controlled interest rates appear to be the most serious issues currently facing the banks. Honduran bankers have little experience with inflation. While inflation may offer the banks some relief with regard to non-performing loan portfolios by reducing the real value of these bank assets over time, inflation will force interest rates up to levels where many clients will be unable to maintain their loan amortization obligations. In the short run this phenomenon will identify those borrowers which evidently cannot adapt to the financial adjustment. It will be important for the banks to learn early on which are the borrowers which simply need a little time to make financial adjustments and those who simply cannot survive without the traditional subsidies of the past. Financial liberalization will require that banks become more skilled at financial analysis techniques in order to sort out the attractive borrowing clients. Additionally banks will need to learn more about credit administration techniques, remedial loan management procedures and how to run effective suspense, or bad loan collection, units. Once again, there is significant opportunity here to provide mich needed technical assistance and training in:

financial analysis /basic finance

term/cash flow lending techniques

loan initiation/analysis techniques

credit administration procedures

loan documentation management

internal credit review systems

legal actions and foreclosure

4.182 Regulatory issues

! <u>Bank Pricing Policies</u>. Bankers complain about the controlled loan interest rates and high reserve requirements. However, most seem to have found ways to operate profitably, often by taking advantage of Central Bank rediscount programs, charging high commissions for making loans, requiring compensating balances and/or by having access to plentiful low cost funds.

It is too early to tell what will be the long run effect of the interest liberalization which took place in October of 1990. Until that time the financial system had been so repressed that **<u>all</u>** bank pricing decisions were established by Central Bank regulation. This repression had the effect of severely limiting the banks' ability to compete with each other. The implicit tax inherent in the high reserve requirement made intermediation very costly and growth very difficult. As a result, banking groups have begun to look outside of the banking area, toward establishing unregulated/informal types of financial vehicles where intermediation activities can be carried out without limitations on pricing. Finance/leasing/small loan companies, etc.) In spite of the October interest rate liberalization pressure still exists for the banks to carry out their intermediation activities outside the formal system because of the continued high level of reserve requirements. As a result it is imperative that the recommendations made in Chapter 2 with regard to the reduction of reserve requirements be carried out to overcome some of the distortions pointed out above.

! <u>Self-Regulation Issues</u>. The quality and financial health of the banks depends mainly on the quality of ownership and management. The Superintendency is perceived to have a reasonably qualified staff but no power. Fines are minimal and there exists a rich history of banks which have used financial and political power to prevent the Central Bank and the Superintendency from enforcing disciplinary actions. While this issue is dealt with in greater depth in Chapter 7, it is so important that it must be pointed out here, again. A strong Superintendency, with the power to demand discipline and excellence from bank management and ownership is a prerequisite to a healthy financial system.

Many of the specific recommendations for improving the operations of the commercial banks will necessarily coincide with policy and legal reform proposals suggested elsewhere in the report. However, some of the most relevant recommendations are as follows:

1) Interest rates should continue to be deregulated and allowed to ease upward so that the banks can offer instruments which will be competitive with government bonds and foreign currency alternatives. Bank portfolios are generally of a short term nature (less than 360 days). Consequently, it is anticipated that banks will be able to adjust their lending rates accordingly in order to maintain their spreads. It is probable that increasing deposit and lending rates to real levels (i.e., over 35% - 38% p.a.) will cause significant loan amortization problems thereby exacerbating bank portfolio problems. Nevertheless, it is necessary to identify, and weed out, those borrowers who cannot survive unless they receive financing at negative real rates of interest.

2) Regulatory accounting and reporting requirements should be modified so as to provide for more meaningful information on and standardized treatment of past due and matured loans. Information should be generated and processed so that it can be used for managerial decisionmaking by the Superintendency and by the banks themselves.

3) In support of recommendation #2 above, standard methodology for review and classification of problem loans should be implemented by the Superintendency. Implementation of the asset review process should be carried out internally by each bank and **each bank's <u>asset review process</u> should be subject to audit by the Superintendency**. Qualitative review of the efficacy of each bank's process and the imposition of penalties for banks with unacceptably inferior processes will place the responsibility for maintaining asset quality, and acceptable credit procedures, squarely upon each bank. The implementation of an asset review process will also facilitate the audit process carried out by external auditors.

4) Income tax regulations and practices should be modified to provide for the tax deductibility of charges to earnings to create provisions for loan losses. This will provide an incentive for the banks to accrue and maintain adequate allowances for loan losses and to provide for more timely discontinuance of interest accrual on past-due and matured loans. Once standards for loan classification have been established and adopted by the system any loan classified as "loss" by a bank, and for which the Superintendency concurs with the classification, should be written off or provisioned against current earnings with full deductibility recognized by the tax authorities. By the same token, the Superintendency should establish guidelines for the establishment of reserves for loan losses. Such charges to current period earnings, which are in accordance with Superintendency guidelines, should be accepted by the tax authorities for full deductibility from taxable earnings.

5) A major problem in Honduras lies in the efficiency and consistency of the judicial system. This is not an unusual problem in developing countries, but, nevertheless, it presents significant disincentive to the allocation of credit by banks in the system. In particular, lending in the rural areas, where land reform has clouded the validity of land titles, is particularly difficult. Moreover, banks report that they face constant and prolonged (several months, or even years) litigation to recover credits which have not been repaid in accordance with the terms of the loan agreement. Moreover, a client who wishes to contest litigation can tie up the case in court practically indefinitely with a clever lawyer and, often, spurious arguments. It is recommended

that a major study to improve the judicial process in the settlement of civil claims be carried out so that reforms can be implemented which will facilitate financial intermediation and commerce.

4.2 The Savings & Loan Associations

4.21 Background.- There are six savings & loan associations (S&L's) in Honduras. Altogether, they represent about 8% of the total formal banking sector assets (government, private commercial banks and S&L's). One of the most striking aspects of the S&L industry in Honduras is the similarity to the S&L sector in the United States, particularly with regard to the problems the sector is currently facing.

Four of the six S&Ls are affiliated with commercial banks (or groups also owning commercial banks) and two are owned by non-financial groups, both of which are heavily engaged in real estate and construction, among other things. Five of the six are considered by the Superintendency and individual bankers to be in good, or acceptable, condition. One is in very bad condition and is under a mild form of intervention, known as "preventative audit" ("auditoría preventiva"), wherein the Superintendency assigns full time inspectors to the institution. Financial analysis performed with the financial data provided by the Superintendency supports the views held by the Superintendency. Ownership and/or affiliation of the six S&L's is as follows:

Institution Ownership/Affiliation

La Vivienda "El Ahorro Hondureño" Group, largely controlled by the Smith family, a wealthy Honduran group, long involved in banking, insurance, and coffee.

La Vivienda de Sula Same as above, but concentrates in the area of San Pedro Sula.

La Casa Propia Banco Atlántida, former Chase Manhattan Bank affiliate and long considered to be one of the two strongest and well managed commercial banks in Honduras.

La Constancia Controlled by Pedro Schmidt who is heavily involved in real estate and construction.

El Futuro Controlled by William Moncada, S.A., heavily involved in real estate, construction (reported to be the most important in Honduras), and construction materials (steel, marble, hardware, etc.).

La Metropolitana Banco Continental group, controlled by Jaime Rosenthal. This group, headquartered in San Pedro Sula, is involved in banking, insurance, and various distribution, activities.

Total assets of the six S&L's as of July 31, 1990, were L.454 million (approximately U.S.$91 million), total loan portfolios were L.345 million (approximately U.S.$69 million) and total deposits were approximately L.232 million (approximately U.S.$46 million). These figures clearly indicate the relatively small significance of this sector. Nevertheless, the six S&L's are quite active and have all shown a profit during the past three years. The related Vivienda and Vivienda de Sula, if taken as one, would be by a small margin the largest S&L. However, the largest single S&L, by far, is La Constancia.

Table 1 illustrates the total assets, total loans, and relative size of the six S&L's, as of July 31, 1990.

Table 1

TOTAL ASSETS OF SAVINGS & LOAN ASSOCIATIONS
July 31, 1990
(figures in thousands of Lempiras)

Institution	Assets	Percent Share	Loans	Percent Share
Vivienda	72,013	15.9	55,608	16.1
Vivienda de Sula	71,564	15.8	62,348	18.1
Casa Propia	30,865	6.8	27,408	7.9
Constancia	158,403	34.9	105,566	30.6
Futuro	94,433	20.8	71,248	20.7
Metropolitana	26,240	5.8	22,679	6.6
TOTAL	453,518	100.0	344,857	100.0

Most S&Ls specialize in financing middle-class housing for terms ranging from 10 to 20 years. Several have diversified in varying degrees into commercial lending and non-housing personal (consumer) lending. These non-traditional activities have proven disastrous for many S&L's in the U.S. and have contributed to the problems at the one highly troubled S&L in Honduras.

All have portfolios with varying amounts of long-term, low fixed rate mortgage loans. This type of portfolio has helped sink some of the older S&L's in the United States and always represents a potential problem if, and when, inflation becomes significant. Several S&L's appear to have this problem under control as new lending includes interest rate adjustment provisions in the promissory notes and some have such provisions in old notes. Several S&L's will suffer from depressed earnings, but probably not be in danger of failure, as old fixed rate loans amortize.

Inflation is having the effect of greatly increasing the value, in nominal terms, of the underlying collateral as compared to loan balances. So far, mortgage loans in Honduras have not been made with terms providing for any sort of value maintenance of principal. This means that even where certain loan programs have involved relatively low down-payments, owners' equity in the underlying real estate has increased considerably with inflation relative to the mortgage debt held by the S&L's. Because of this more-or-less rapid increase in equity, borrowers quickly develop a substantial interest in their homes which serves as motivation for them to find a way to keep up payments on their mortgages. For this reason defaults on housing related loans should not increase in the foreseeable future.

Nevertheless, the above situation is not healthy and it involves significant transfers of wealth to borrowers, essentially at the expense of the few depositors left who are still willing to invest in Lempira denominated financial assets. In the face of inflation, variable rates of interest based on a **freely determined market index** must be implemented soon to stabilize this financially distorted situation.

4.22 Sources of Loanable Funds.- As mentioned above in the discussion of the commercial banking system, the large pool of pension fund monies provides an important source of deposits for the financial system. The S&Ls also depend, to a large degree, on the pension funds to fund their mortgage portfolios. While pension fund resources are inherently medium to long term resources, and the loans made by the S&Ls are also primarily medium to long term, intermediation between the pension funds and the S&Ls is still carried out, essentially, on a short term basis.[1] The S&L's depend for funding, to an even greater degree than the commercial banks, on Central Bank rediscount facilities, especially the "Fondo de Vivienda". The ability of most of the S&L's to extend new financing in recent years has depended on usage of this rediscount facility.

In summary, continuing substantial inflows of pension fund deposits, together with the S&L management's recognition of the need to use loan documentation providing for interest rate flexibility, bode well for the health of this sector in the near term. In the long term, however, cash flow will become strongly negative as the need of the pension funds to withdraw short-term deposits will far out-strip the S&L's inflow of funds from repayments of long-term mortgage loans. When this occurs, the S&L sector will experience severe liquidity problems which would probably be solved by even more massive support from the Central Bank. It would, therefore, seem to appear that the future of the S&L's might depend on the Government's long-term commitment to support the sector by providing financing at a rate of interest below the rate being earned on rediscounted assets and the ability of the S&L's to charge real rates of interest on loans that are not eligible for Central Bank support. While the government may be required to provide some support to S&Ls with existing low yielding portfolios, on which the yield cannot be improved, such support should be established in such a way as to wean the S&Ls away from subsidized, directed credit lines. In no way should any new loans be made with subsidized, directed credit. S&Ls, if they are to survive in the long term must be provided with the incentives to mobilize deposits to support their loans.

4.23 Financial Condition.- At the present time, five of the six S&L's appear to be in reasonably good condition. The other appears to be completely insolvent and is being kept on "life support" by the Central Bank. It should probably be liquidated and its good assets and premises be sold to healthy institutions. However, the Superintendency of Banks and the Central Bank are inexperienced in the intervention and liquidation of financial institutions and are postponing the inevitable.

As with the commercial banks, there are serious threats to the S&L system as a whole. At least some Honduran bankers and S&L managers appear to be fully aware of the dangers. One S&L manager stated openly that all six S&L's could be in danger of bankruptcy, primarily because of the funding and interest rate issues discussed above. It is not inconceivable that funding shortages could eventually cause the S&L's to shrink considerably in size, eventually to a point that they are no longer viable.

Notwithstanding the threats to the S&L system and their questionable future viability, they are, after all, a relatively small part of the Honduran financial system and could theoretically be absorbed by the commercial banking system. In other words, the future of the Honduran financial system is not going to be profoundly affected by what happens to the S&L's. However, if the S&L industry were to collapse it would be a severe blow to housing finance in Honduras. It is important, therefore, to

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[1]Capital markets, which are markets for equity finance and medium and long term debt are underdeveloped in Honduras. In part, because directed credit lines have sought to provide term finance, at a cost to the borrower which was often **<u>lower</u>** than the cost of regular short term debt, financial intermediaries have not had an incentive to mobilize any resources for the medium or long term. At the same time, the interest rate ceilings established by the Central Bank regulators never established any premium of any sort for either depositor or lender committing resources for more than the short term. Please refer to Chapter 6, Capital Markets, for a more detailed discussion on this subject.

go forth with the critical policy reforms recommended in this report that will eliminate the financial distortions that are currently impacting the sector.

The principal recommendations to assist the S&L sector are the same ones mentioned earlier in the section which discussed the commercial banking system. However, the following additional specific recommendations are made:

1) A brief study should be undertaken of the non-housing lending activities of the S&L's in order to determine what, if any, reasonable limitations should be placed on those activities to prevent some of the negative consequences observed in the United States as a result of deregulation. The one Honduran S&L in serious trouble is, itself, a victim of having strayed from its area of expertise.

2) In the event that the S&Ls do not appear to be viable in the long run, consideration should be given to studying the feasibility of creating multipurpose banks out of the commercial banks and merging the S&Ls into the banking system. This should not be very difficult inasmuch as all but two S&Ls are controlled by a commercial bank. If the appropriate liberalized financial policy initiatives recommended in this study are implemented there would be little negative impact to Honduran housing finance. On the contrary, strengthened financial institutions, operating in active capital markets, may be able to mobilize loanable housing finance resources more efficiently than small S&Ls.

4.3 Government Financial Institutions - BANADESA

4.31 Background.- The most significant recent change in BANADESA's activity is that its current management is operating without apparent interference from the Government. Gustavo Zelaya, the General Manager of BANADESA, was appointed in February 1990 and is reported to enjoy the full support of Honduras' President Callejas. Zelaya has continued certain projects of the previous General Manager and has embarked upon new projects. Notably, BANADESA is involved in an intensive effort to reduce past-due loans and aggressively pursue the collection of old problem loans. Also, Zelaya has reduced BANADESA's staff from over 1,100 to about 700 as of the end of November and intends to reach a target staff of 600 at the end of 1990.

BANADESA management has completed a comprehensive analysis of the profitability of the agencies and has identified certain ones for closing and others for down-sizing. Specific steps to improve others have been established.

BANADESA management is also studying ways by which larger borrowers can be transferred to private sector banks and by which non-banking activities can be eliminated.

Lending authorities have been reduced in the agencies. Loan approval authority has been concentrated in senior management and removed completely as a function of the Board of Directors. This concentration of lending authority has been instituted as part of an effort to exert greater control over the loan initiation process. Centralization could prove counterproductive in the long run, however, inasmuch as day to day credit approvals by senior management may not be an appropriate activity for such high level personnel. Thus, senior management may become a bottleneck in the approval process. It may be preferable to exert control over credit initiation in the field through a decentralized credit approval approach by establishing a better monitoring process whereby senior management can keep abreast of the decisions taken in the field. For the moment, however, little has been done to prevent some of the abuses of the past from occurring again.

4.32 BANADESA and the Recommendations of the Task Force on Agricultural Financial Sector Reform.- BANADESA appears to have reached another important crossroads in its institutional evolution. The time is ripe for BANADESA and government policymakers to carefully rethink the appropriate role for the institution within the financial and rural sectors. In this regard, the task force established by the government to rethink the structure of the agricultural sector has recently published a report[2] making several recommendations as to the appropriate role for the institution. The report generally concludes that BANADESA's scope should be sharply reduced to that of providing services for only the lower end of the rural financial market. BANADESA would only make loans to small producers, up to a maximum of L.100,000; BANADESA would provide full banking services in the rural areas of Honduras, to include small scale credit and deposit services to be provided through decentralized units to be known as "Cajas Rurales"; BANADESA would liquidate, sell, or otherwise shed all of its trust ("fideicomiso") activities; finally, BANADESA would become the **only** vehicle through which the government would channel credit or guarantees to the agricultural sector.

In view of the consistently negative history of this institution, any downscaling of the size of BANADESA can be viewed as a positive development. While it may not be politically feasible to consider shutting down BANADESA completely, limiting its activities as described above is certainly a positive development. If financial liberalization were to really take place in the agricultural sector it is probable that commercial banks and other formal and informal financial intermediaries will increase their activities significantly to fill the void left as a result of the downscaling of BANADESA's activities. All efforts to reduce the scope of this institution in favor of liberalized financial market activity are viewed positively, to include the possibility of eventually phasing out the need for this institution completely.

In the meantime, BANADESA should respond to the recommendations of the task force's study by carefully defining their role for the immediate future. It is recommended that management and policymakers proceed with the development of a carefully thought out **strategic plan** for the institution in the context of a significantly modified scope of operations.

In summary, BANADESA management has taken some initial steps toward placing the institution on a sound operating basis. There remains, however, substantial work to be done to convert the institution into an entity capable of efficient intermediation of rural financial resources.

4.33 BANAGRO.- The task force goes on to recommend the creation of another entity referred to as BANAGRO for the purpose of taking over much of the portfolio to be shed by BANADESA. There exist serious shortcomings in the widely discussed idea of a new agricultural bank. Among these shortcomings is the idea of giving favored treatment to BANAGRO in the purchasing of some of the assets to be shed by BANADESA. If the new bank is to be of mixed capital, there does not appear to be a need for another Government or quasi-Government agricultural bank. If the new bank is to be truly a properly capitalized private sector entity, the creation of this entity should be encouraged as an additional competitive force interested in further developing the markets for agricultural finance in Honduras. If it is chartered, however, it should have no preferential opportunity to purchase Government assets (loans from BANADESA). It should have the

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[2]Grupo Técnico de Trabajo sobre el Sector Financiero Agrícola, **Las Políticas y la Estructura del Sector Financiero Agrícola, (Borrador),** Tegucigalpa, D.C., October 30, 1990.

opportunity to bid on assets offered on the same basis as any other eligible bidder (presumably only commercial banks). Furthermore, a new bank which would pretend to serve the agricultural sector throughout Honduras, as would be necessary if it is to buy all of the available BANADESA loan portfolio, would need a significant branch network throughout the country. That seems to be a very ambitious undertaking for a new financial institution. It is doubtful that organizers of a new bank in Honduras in the current economic climate could raise sufficient capital to mount (or buy from BANADESA) an adequate branch system to serve the agricultural sector throughout most of Honduras.[3]

4.34 Recommendations.-

It is recommended that no position be taken regarding the possible formation of a new agricultural bank (BANAGRO) if it is truly to be a well capitalized private endeavor. It is recommended that the creation of yet another public sector financial institution be opposed.

It is also recommended that the Government of Honduras seriously consider liquidation or privatization of BANADESA within a relatively short time frame (two to three years). There is little evidence in the world that public sector financial institutions can operate efficiently. Currently, there is no evidence of this in Honduras. In the long run, if BANADESA is to survive, there really is no viable way to insert the appropriate incentives for self sustainability or profitability. Moreover, it is likely that, with time, and under another government, all of the traditional political pressures to distribute credit at subsidized rates, and which have consistently contributed to the problems at BANADESA, are sure to reappear.

If liquidation of BANADESA is not viable for financial and/or political reasons, BANADESA should take every reasonable preventive measure (several of which have already been taken) to ensure that BANADESA is isolated from political abuse, especially in its lending operations. Assets and liabilities not directly related to BANADESA's activities as a bank specializing in agricultural lending should be removed from BANADESA's balance sheet and transferred elsewhere. BANADESA should be managed as a profit-making institution with direct subsidies, if needed, provided by the Government in a transparent manner.

In the short run, BANADESA Management should carefully rethink BANADESA's role in the financial and agricultural sector by preparing a comprehensive **strategic plan**.

In the short run, it is recommended that BANADESA set a maximum size of borrowing relationship which it will generally desire to serve, e.g., L.50,000. The figure should be subject to periodic adjustment to keep up with inflation. BANADESA's goal should be to 'graduate' its customers to the private sector banks as customers' borrowing needs and creditworthiness grow.

In conjunction with the effort to limit BANADESA's lending activities, BANADESA should attempt to persuade all existing borrowing customers which have a borrowing relationship of, e.g., L.50,000 or more (or likely to require L.50,000 or more in the near future) to transfer their borrowing relationships to other banks. This process should be facilitated as much as possible by BANADESA management.

4.4 Specific Recommendations for Financial Institutions - Summary

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[3]IMCC, Honduras-Feasibility of Sale of BANADESA Loan Portfolio and Viability of Establishing a New Agricultural Bank, A Report to the World Bank, December, 1990, page 5.

- o Facilitate the development of formalized, on-going training programs (described in 4.181, above) to assist financial institutions with the modernization and liberalization process that will inevitably result from policy recommendations recommended in Chapter 2.

- o Provide technical assistance to the banking system, through the Superintendency of Banks, or through the Bankers' Association, to facilitate the implementation of **credit process management and credit review** related recommendations suggested in Chapter 7.

- o As suggested in the specific recommendations under 4.32, above, serious consideration should be given to liquidation or privatization of BANADESA. It will be difficult for market mechanisms to effectively intermediate financial resources in the agricultural sector while BANADESA continues to operate under pricing standards that are not market determined (and with different credit standards) in competition with the private sector (both the formal financial institutions and the informal financial system).

- o Conduct a review of all existing legislation, Central Bank regulations and other constraints upon the banking system that inhibit open competition among financial institutions. Develop a plan to dismantle barriers to competition. The results of this survey must be incorporated into any overall plan to modernize current banking legislation.

5.0 PENSION FUNDS AND INSURANCE COMPANIES

5.1 Pension Funds

5.11 Background.- This section of the report will describe the overall structure of pension funds in Honduras and the role of the pension fund system as an important player in Honduran capital markets will be examined. In this regard, the long term viability of the system will be assessed. It will therefore, be necessary to comment on some of the technical aspects of the funds' portfolio management practices in order to gather a broad idea as to the long range solvency of the system.

Over the years, many studies have been carried out with regard to different portions of the Honduran financial sector. Nevertheless, with the exception of a report prepared in 1989 by the "Miguel Kast Foundation" there is virtually no existing analytical work on the Honduran pension fund system. Moreover, most of the pension funds are not subject to supervision by any government entity. (Only one of the pension funds, -INJUPEMP- is subject to supervision by the Superintendency of Banks); it was not possible, therefore, to obtain readily assembled statistical information with which to carry out the analytical work easily. As a result, much of the knowledge gleaned about the system, in the preparation of this report, resulted from direct interviews with high executives of the different pension funds and from data which was provided directly by these fund managers. While some of the pension fund managers were very cooperative in providing data for the study, the consulting team experienced difficulty in obtaining meaningful data from others.

5.12 Description of the Funds.- There exist in Honduras <u>seven</u> pension fund programs which are each administered by an independent institution or autonomous agency. The programs are the following:

1.- The **Instituto Hondureño de Seguridad Social (IHSS)**[4] This program provides benefits to cover death, disability and old age.

2.- The **Instituto de Jubilaciones y Pensiones de los Empleados y Funcionarios del Poder Ejecutivo (INJUPEMP)**.[5]

3.- The program created to benefit school teachers and school system employees **Instituto Nacional de Previsión del Magisterio (INPREMA).**[6]

4.- The program created to provide benefits to the Honduran Armed Forces, which is known as the **Instituto de Previsión Militar (IPM).**[7]

5.- The program created to benefit the employees of the Central Bank of Honduras, which is known as **Plan de Asistencia Social (PAS).**[8]

6.- The program created for the benefit of journalists and newspaper employees, which is known as the **Instituto de Previsión Social del Periodista (IPP).**[9]

7.- The program established to benefit employees of the National University, which is known as the **Instituto de Previsión de la Universidad Nacional Autónoma (IPREUNAH)**.[10]

It can be observed that the programs have been largely created by legal intervention. Only in the case of the Honduran Central Bank and the University have the funds been created through board resolution. It can be observed that the pension funds are a relatively new phenomenon. Three of them (IHSS, INJUPEMP and INPREMA) began operations during the seventies. The others were created in the eighties. Generally, it can be observed that participation in the seven groups is mutually exclusive, i.e., a member cannot participate in two pension plans at the same time. Coverage under the different plans has expanded gradually. Indeed, the IHSS law and the IPM law require measured growth, primarily to ensure financial stability of the fund. It is noted that only a relatively small proportion of the economically active population of the country are beneficiaries under the pension fund programs.

There exist some important differences in the benefits provided by the different programs. Some of the institutions (IHSS and IPP) orient their benefits exclusively toward the area of health and retirement. The rest, instead, focus their plans on disability, old age and death benefits. There does

[4]Created by law in 1959 but not established until 1972.

[5]Created by decree-Law # 138 of February, 1971. This law is known as the Ley de Jubilaciones y Pensiones de los Empleados y Funcionarios del Poder Ejecutivo.

[6]Created under Decree-Law # 84 of December 1970. This law was subsequently abolished and replaced by Decree-Law # 1026 of July 1980.

[7]Created by Decree-Law # 903 which became effective in March of 1980 and replaced Decree-Law # 88 of October 1973.

[8]Created by resolution of the Board of Directors of the Central Bank.

[9]Created under Decree # 180-85 of December 1985.

[10]Created by the University Council in June of 1989.

not appear to be any uniformity of criteria in terms of retirement age, vesting, etc., among the different funds.

5.13 Administration and regulation.- As mentioned above, each of the funds is administered by an autonomous entity with its own net worth. Each one of these entities has an internal auditor and its operations are subject to external audit by the Comptroller General of the Republic. Nevertheless, the pension funds are not regulated, nor are they subject to technical-actuarial audit, with the exception of INJUPEMP, which is the only institution subject to supervision by the Superintendency of Banks.

5.14 Contributions.- Contributions to the pension plans vary from fund to fund. This can be seen from the table below:

Contributions to Pension Plans
(by percentage of salaries)

	WORKER'S	EMPLOYER'S	GOVT'S	
PLAN	CONTRIB.	CONTRIB.	CONTRIB.	TOTAL
~~	~~~~~~~~~~	~~~~~~~~~~~	~~~~~~~~~~	~~~~~~~
IHSS	1.0%	2.0%	1.0%	4.0%
INJUPEMP	7.0%	11.0%		18.0%
INPREMA	7.0%	11.5%		18.5%
IPM				[11]
PAS				[12]
IPP	3.5%	10.0%	5.0%	18.5%
IMPREUNAH	7.0%	4.5%		11.5%

5.15 Legal limitations to Investment.- In general, legal limitations with regard to investments permitted by the funds are non-existent. The law merely provides the obvious guidance to prudence with regard to risk versus return criteria. As a result, the management of the funds is at liberty to make investments in any type of asset or financial instrument which fits within the guidelines established from time to time by the fund Directors.

There are some significant adverse pressures which affect management in their investment decisions:

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[11]The actual percentages are not known. However, it is known that one third is contributed by the worker and two thirds is contributed by the Government.

[12]Information was not available.

1.- The "healthy", but not always technically correct, tendency to minimize risk at all costs, thereby sacrificing overall portfolio return objectives.

2.- The enormous pressure to grant subsidized loans to the beneficiaries of the funds to the detriment of the overall yield of the portfolio and to those beneficiaries who do not borrow.

3.- The inefficiency of the existing money markets and capital markets in Honduras and the inexistence of a secondary market for financial instruments. (The lack of a secondary market makes it very difficult for portfolio managers to estimate the market value of the assets in their portfolios.)

5.16 Assets, reserves and net worth.- The table which follows estimates the assets and technical reserves, by fund, as of December 31, 1989.

	(1)	(2)	
		TECH. RES. +	RATIO
INSTITUTION	ASSETS	NET WORTH	2/1
~~	~~~~~~~~~~	~~~~~~~~~~~~~~	~~~~~~~~~~
IHSS	348.02	347.99	1.00
INJUPEMP	594.60	534.06	0.90
INPREMA	537.43	487.86	0.91
IPM	220.00	199.00	0.90
PAS	68.08	68.08	1.00
IPP	4.45	4.36	0.98
IMPREUNAH	9.00	9.00	1.00
	-------	-------	-------
TOTAL:	1,781.58	1,650.35	0.93

In a very short period of time the total assets of the seven funds have grown to a significant L.1,781 million. This compares with total financial assets in the commercial banking system of L.4,618 million as of July 31, 1990. Of this figure, approximately 93% represents investments of the technical reserves and accumulated capital of the funds.

It is interesting to note that the four largest funds account for 95% of the volume of the pension fund investments in Honduras reporting total assets of approximately L.1,700 million. The other three (PAS,IPP, and IMPREUNAH) account for less than L.100 million.

5.17 Pension Fund Portfolios.- Investment portfolios vary from fund to fund. The table below describes how each fund has allocated its portfolio:

Portfolio Distributions - Honduran Pension Funds
(Millions of Lempiras)

	LT						ADV. TO		
	GOV'T	BANK	PERSON AL	MTGE	REAL	CORP .	HEALTH		TOTAL
INSTITUTI ON	BONDS	DEPOSIT S	LOANS	LOAN S	ESTAT E	EQUI TY	MTERNT Y	OTHE R	SYSTEM
~~ ~~	~~~~~~ ~~	~~~~~~~ ~~	~~~~~~~ ~~	~~~~~~ ~	~~~~~~ ~	~~~~~ ~	~~~~~~~~ ~~	~~~~~~ ~	~~~~~~~ ~~
IHSS	142.0	72.3					124.3	9.5	348.0
INJUPEMP	285.7		53.6	140.5				54.4	534.1
INPREMA	181.9		139.8	143.7				22.5	487.9
IPM	22.0	65.1	18.9	27.4	23.7	29.9		12.0	199.0
PAS	35.8		6.7	25.4				0.2	68.1
IPP	0.5	1.4	0.3	1.3				0.8	4.3
IMPREUN AH		6.0	3.0						9.0
	-----	-----	-----	-----	-----	-----	-----	-----	-----
TOTAL:	667.8	144.8	222.2	338.3	23.7	29.9	124.3	99.4	1,650.3
% OF TOTAL:	40.5%	8.8%	13.5%	20.5%	1.4%	1.8%	7.5%	6.0%	100.0%
AVE YIELD:*	12.0%	10.5%	13.0%	9.0%	unk	unk	0.0%	unk	

*("Average yield" is estimated based on information collected from each pension fund. For more detailed information on individual funds please refer to the technical report on pension funds).

It can be seen from the above that the primary investment vehicle for the pension funds are government bonds which account for 40.5% of the overall portfolio. Although bond investments are made in both long and short term instruments, inasmuch as the Honduran Government will redeem bonds "on demand" these instruments essentially are all short term investments. It is expected that the nominal average yield on these investments will show an increase for 1990 and 1991 as inflation continues unabated.

Investments in bank deposits, while critically important to the banks as an important financial resource, surprisingly only account for 8.8% of the total. Yields are slightly lower than for government bonds.

A disturbingly high percentage (34%) of the funds' resources are invested in relatively low yielding loans to beneficiaries of the funds. It would appear from this that there exists a fundamental philosophical conviction that beneficiaries should take advantage of their savings now rather than wait for benefits at retirement. Clearly, by borrowing today at subsidized rates significantly below the rate of inflation, the value of the funds is being eroded to provide for instant gratification. This does not bode well for the long term health of the funds.

If the fiscal deficit cannot be brought under control within a very short timeframe (one year), inflation will continue at double digit levels (30%-40%p.a.). At these rates the real value of the funds' assets will be wasted and reduced to a fraction of their present value within three years. Little is known about the funds' investments in real estate and corporate equity (real estate and corporate equity represent a very small share , however) or whether fund portfolio managers have the ability to make good real estate investments. However, unless financial assets yielding positive returns become available for investment in Honduras, real estate may be the only area for portfolio managers to defend themselves from the enormous negative real yields currently being obtained. There was little evidence that portfolio managers in Honduras are aware of what is happening to the real value of the funds. Certainly, the beneficiaries of the funds do not seem to understand clearly the magnitude of the decapitalization which is taking place as a result of inflation. This is an area for immediate attention. Again, the solutions for these problems lie in the macrofinancial and fiscal policy arenas.

The enormous growth of these funds, both in nominal terms and relative to the overall size of the financial sector, underscores the potential to utilize these resources for the development of an active capital market. Pension fund resources are essentially long term resources and should become the backbone of the market for long term finance in Honduras. Care should be taken not to undermine the agile intermediation of these precious resources with artificially administered and improperly priced long term sources of funds available under rediscount programs.

5.2 Insurance Companies

5.21 Background.- There are presently eight Insurance companies operating in Honduras. Of these, six are local companies and two are foreign owned. The companies primarily sell the following insurance products:

life insurance
accident insurance ocean and land transport insurance
fire hazard insurance
automobile insurance
air travel insurance
civil and professional liability insurance
bonds and guaranties

The insurance industry is regulated by the "Ley de Instituciones de Seguros"[13]

This law establishes that the insurance industry is subject to the regulation, control and supervision of the Superintendency of Insurance. At the same time the law regulates the investments of capital and reserves of the insurance companies. Generally, with respect to investments, insurance companies are permitted to invest across a broad spectrum. Specifically, technical reserves must be invested in:

* Instruments eligible for the "Securities Fund" of the Central Bank

[13]Decree # 28 of February, 1983.

* Income producing Real Estate
* Mortgage secured loans
* Corporate Stock
* Loans secured by chattel mortgages
* Loans secured by the cash value of life insurance policies

Limits are placed on the investments in real estate as well as corporate stock. Investments are limited to 25% of the equity of a corporation. Moreover, the law sets forth that the insurance industry must be governed by regulations, from time to time issued by the Board of Directors of the Central Bank.

It is important to note that the most restrictive barriers to investment are those originated through the regulatory powers of the Central Bank. Some of the restrictions have had a profound impact on the insurance companies' ability to invest their reserves:

* The obligation to invest at least ten percent of technical and mathematical reserves in securities issued by the Government Housing Finance Company (FINAVI)

* the requirement to invest ten percent of capital in CONADI

* the limitation prohibiting insurance companies from investing in bank time deposits beyond the value of securities held which are eligible for the "Security Fund" of the Central Bank

* The establishment of maximum interest rates

5.22 Assets of Insurance Companies.- As of December 1989 total assets of the insurance companies stood at L.312 million. This amount can be broken down as follows:

	Amount	Percentage
Local companies	238.55	76.25%
Foreign companies	74.29	23.25%

It should be further noted that as much as 72% of total assets of insurance companies are represented by "investments".

Breakdown of Investments as of 12/31/89

			LOCAL		FOREIGN	
INVESTMENTS	TOTAL	%	COMPANIES	%	COMPANIES	%
~~	~~~~~~~~~	~~~~~~~~~	~~~~~~~~~	~~~~~~~~~	~~~~~~~~~	~~~~~~~~~

SECURITIES	L.62.06	27.5	L.48.39	29.7	L.13.67	22.0
LOANS	132.09	58.6	92.26	56.5	39.83	64.0
BANK DEPOSITS	11.17	5.0	5.60	3.4	5.57	8.9
REAL ESTATE	13.13	5.8	9.97	6.1	3.16	5.1
OTHER	7.04	3.1	7.03	4.3	0.01	0.0
	-------	-------	-------	-------	-------	-------
TOTAL:	L.225.49	100.0	L.163.25	100.0	L.62.24	100.0

It is important to note that the principal area for investments are loans. Loans are basically of two types: Real estate or chattel mortgage secured loans which bear an interest rate of 17%p.a., (or the maximum rate permitted by the Central Bank) and loans against the cash value of insurance policies, which earn a reduced rate of 6% to 10%.

The second most important area of investment are government securities. Included in this category are the forced investments in FINAVI (which only yield 8% p.a. and CONADI (most probably worthless).

5.23 Regulatory issues.- There are three primary problem areas that must be pointed out with regard to the regulation of insurance companies:

1.- The lack of power, of the Superintendency to effectively require full compliance with the insurance law; there are many unregulated insurance companies that routinely sell life insurance to Hondurans from abroad. Not only is this a problem because of the lack of supervision of these "pirate" companies, but their very presence in the market indicates that market distortions are preventing domestically regulated companies from providing a insurance product that is in local demand.

2.- The lack of regulation and control over reinsurance companies who, <u>by and large are not located in Honduras and, therefore, beyond the control of the regulatory authorities</u>

- The Superintendency does not require, and therefore, does not review, the financial statements of any of the reinsurance companies.

- The Superintendency does not require any approval in the selection of reinsurance companies.

- The Superintendency does not control or review the premiums or commissions paid to reinsurance companies by the insurance companies in Honduras. (Only 3.99% of reinsurance payments made by Honduran insurance companies were made to local companies subject to supervision by the Superintendency).

This is, therefore, and area where opportunities exist for exporting profits or capital flight. Ordinarily, under a liberalized financial regime capital flight would not be an area where regulation would be advocated. This merely serves to point out that because the financial system has in the past been, essentially, a repressed one, that regulatory distortions have probably found an escape valve for capital flight through the payment of reinsurance premiums. It is not recommended that the regulators attempt to prevent capital flight through limitations placed on reinsurance payments, but rather that the superintendency monitor the quality of the reinsurance coverage given to the companies operating in Honduras.

3.- The lack of tools (human resources, technical specialist, equipment, software, and adequate information) so that the Superintendency can adequately carry out its function of actuarial supervision. It is important to note that:

- The actuarial-mathematical review performed by the Superintendency on insurance premiums and reserves is very limited; policies, procedures or technical manuals describing actuarial methods and standards permitted in Honduras either do not exist or could not be found.

- There is no statistical data bank available in the country to keep track of insurance claims in Honduras. It is imperative that such a data base be developed, for use by all insurance companies, as well as the Superintendency, so that premiums and reserves can be mathematically calculated and established in accordance with adequate actuarial procedures.

5.3 Specific Recommendations Regarding Pension Funds and Insurance Companies.-

- o Facilitate the development of a seminar, adapted to the Honduran context, on macro-financial issues, capital budgeting, bond yields and short term investment for the participation of pension plan managers and staff.

- o Facilitate the development of a statistical data bank to record statistics on insurance claims. This will permit insurance premiums and reserves to be mathematically calculated.

6.0 CAPITAL MARKETS

6.1 Definitions- "**Financial markets** can be defined as composed of **1)-Money Markets** (which provide short term funds for meeting fluctuating needs) and **2)-Capital Markets** (which provide medium and long term funds to meet permanent working capital needs and to finance fixed assets. In turn, **Capital Markets** can be further defined as consisting of two segments, namely 1)-Non-Securities Markets and 2) Securities Markets. In general, the non-securities markets provide **non-negotiable** medium and long term debt through financial institutions such as commercial banks, development banks, savings banks, insurance companies, pension funds, leasing companies, etc. Typical instruments used in the non-securities market are loans, mortgages, leases and sale and leaseback agreements. In contrast, securities markets provide for medium and long term debt through instruments which are **negotiable**. Thus, long and medium term financing needs can be documented through shares or stocks (equity), convertible bonds or debentures (equity equivalents) or bonds or debentures (medium and long term debt). Because of the negotiable aspect of securities, the securities market can be further broken down into the **primary market** and the **secondary market**. The principal players in the primary markets are Corporate and Government issuers, Investment/Merchant Banks, Securities and Regulatory bodies, Debenture trustees, Brokers/Dealers, etc. In the secondary market the principal players are the Securities Exchanges, the Clearance and Settlement Agencies, Transfer Agents, Mutual Funds and Broker/Dealers.

The Money Market can also be segmented into non-securitized and securitized markets. Typical examples of non-securitized money market instruments are demand and short term bank loans, discounts etc. Examples of securitized money market instruments are short term government securities (Treasury Bills) and Corporate commercial paper.

6.12 Fragility of Financial Markets.- Financial markets are closely interrelated. Supply, demand and interest rate fluctuations in one financial market segment will necessarily have some effect on the behavior of the other segments. Central Bank monetary policy and regulatory practices applied to any one of these market segments will have their impact felt, to some extent, in all of them. Financial markets, by their very nature, are more responsive to outside stimuli than other major markets such as Goods and Services and Labor. Because financial markets are so responsive they have the potential to be extremely efficient if they are properly managed. Distortions introduced by inappropriate government policy, however, will necessarily reduce the efficiency of financial markets and can cause financial resources to flow toward less than optimal uses to the overall detriment to the economy. Often, the results of improper or not well thought out financial market management can have surprisingly negative repercussions. Because financial markets are so responsive these results can be observed very rapidly. But, the far reaching impact of these repercussions, to all corners of the financial market matrix, may not always be fully comprehended by policy makers. Legislators, in particular, who may have a narrow constituent base to please, will often support legislation affecting financial markets without thinking through all of the possible implications of the legislation on all segments of the financial markets. Thus, financial markets are fragile and can easily be mismanaged.[14]

6.2 Background.- Against this backdrop the present status of the Honduran capital market can be examined. In reality, all of the above markets exist in one form or another, however, they are generally poorly developed. Because of the repressed history of financial markets in Honduras, significant distortions have prevented money markets from developing much beyond the simple intermediation of short term deposits and short term loans through the banking system.

As mentioned in the previous chapter, medium and long term sources of funds (capital markets) recently made available to the system through the pension funds, which came to life during the seventies and eighties, were never properly intermediated by the system because:

i) of competition from long term resources made available through artificially administered Central Bank directed credit lines at rates of interest often below the marginal cost of mobilizing short term bank deposits, and

[14] IMCC, Philippine Financial Markets Development Strategy, December 1989, page 9.

ii) the lack of an openly traded, securitized secondary market, for medium and long term financial instruments which would provide for

   a) liquidity in the capital market

   b) a freely determined, market index against which the pricing of longer term debt issues could be floated, thereby reducing much of the risk inherent in committing funds to maturities in excess of terms.

6.3 The Honduran Securities Exchange.- The recent creation of the Honduran Securities Exchange comes at a complicated moment in the macrofinancial history of Honduras. Following years of relatively predictable financial activity, the system presently exhibits high levels of inflation and is reeling from the shock of back to back devaluations. At the same time many repressive laws and inappropriate financial market regulations remain on the books preventing financial agents from reacting properly to the crisis. Inasmuch as securities exchanges require the free exchange of information and the unimpeded interaction of supply and demand in order to be effective, much of the existing regulatory framework must be liberalized to permit agile intermediation of financial assets. The current situation of crisis presents opportunities as well as problems for the new Securities Exchange.

6.4 Initial steps to be taken by the Securities Exchange.- Because of the current economic situation and the tight credit policy that will have to be followed in order to combat inflation, the resulting lack of liquidity in the system will necessarily shorten investment horizons. For this reason it is anticipated that the initial activity at the Securities Exchange will be the intermediation of banking products such as certificates of deposit and other short term, negotiable, low risk, instruments that will be fairly easy to place with investors. Subsequently, it is expected that commercial paper guaranteed by banks will be placed. As the investing public and the institutional investors gather confidence with the issues, corporate debt instruments and other debt issues with longer maturities can be intermediated. Finally, and this may take years, it is possible that equity issues will be traded on the exchange.

6.5 Immediate Organizational Needs.- In order for this evolutionary process to take place, modifications and legislative improvements need to be made to the existing regulatory framework. As mentioned earlier, the intricate interrelationship between the different financial markets require that reforms be implemented for the liberalization of <u>all</u> financial markets. The new securities exchange cannot be viewed as the only element for modernization and liberalization of the Honduran financial system.

Additionally, it is imperative that the securities exchange be cognizant, at the outset, of its overall mission and objectives for the immediate future. For this reason it is recommended that an urgent task for the Honduran securities exchange is the writing of a well thought out **strategic plan**. By reviewing strengths and weaknesses in the situation analysis phase of the strategic planning process, a clear definition of mission will emerge, providing for the establishment of specific objectives and the optimum strategies which will permit the accomplishment of set objectives. Subsequently, the strategies should be broken down into action plans which will clearly map out paths for action.

Finally, it is important that the securities exchange achieve successes and positive results rapidly. This can be best accomplished through a three pronged effort:

1.- Develop a formalized training program for the staff and members of the securities exchange in the areas of financial analysis, capital budgeting, and legal and regulatory aspects of securities/banking law. This should include a program for staff to visit other exchanges in countries with similar environments (i.e., Costa Rica, Bolivia, etc.).

2. Develop a formal public relations and promotional program to inform all of the other financial intermediaries, potential corporate clients and certain government agencies as to the overall focus of the strategic plan.

3. Implement the action plans (from the strategic plan) to reform the regulatory framework in order to eliminate as many obstacles as possible to the efficient intermediation of securitized money market and capital market instruments.

6.6 Legal Framework Surrounding the Securities Exchange.- The legal framework needed for agile operations of the Securities Exchange must be a flexible one. The exchange will not be in a position to respond with alacrity to the requirements of the market if the regulatory framework is so restrictive that it must constantly consult, or obtain authorization from, a government regulatory agency on day to day activities. This implies that the exchange must be granted certain powers to police itself. Specifically, it should be able to establish rules for the operations of the exchange thereby **regulating** the activities of the member brokers and other economic agents that interact with the exchange. Secondly, the exchange should have the power to **audit** and **sanction** member brokers and other economic agents. In this manner it can maintain the discipline required to carry out its activities in an orderly manner.

There is no specific law which regulates the activities of the securities exchange. The principal existing laws which govern the financial system, in general, are the following:

1. Código de Comercio (Commercial Code)

2. Ley del Banco Central de Honduras

3. Ley de Instituciones de Seguros

4. Ley Monetaria

5. Ley Para Establecimientos Bancarios

6. Reglamento Para Prestamistas No Bancarios

7. Reglamento de Bolsas de Valores, Acuerdo No 115 del Presidente Constitucional de Honduras, February, 24, 1988.

8. There also exists a draft of a law to govern the Securities Exchange, prepared under the auspices of the Private Sector Federation of Central America and Panama (FEDEPRICAP) which contains many appropriate reforms to the Commercial Code (Código de Comercio). This project constitutes an important effort to provide for complete legislation to govern securities markets based on the experiences of other Central American countries.

There are many changes in the laws which are needed in order to provide the exchange with the flexibility to carry out its mandate. It can be seen, however, that the existing web of legislation and the earlier mentioned interrelationships that exist between the different financial markets, will require that any reform to the securities legislation will necessarily involve reforms to the financial sector in general. Adapting the legal framework to the needs of the Securities Exchange thus requires that an integrated legal reform take place. In the meantime, however, it is appropriate for certain legal modifications to take place as part of a gradual reform to the legislation. Immediate partial reform is, therefore, necessary to establish an aperture for eventual integrated reform. One important reason for this is the conviction that integrated reform should be based on some of the experiences encountered with the initial operations of the Securities Exchange.

6.7 Specific Legal recommendations.- With the intent of defining an initial phase for the creation of, at least, an acceptable legal base for the operations of the Securities Exchange some partial legislative reforms are proposed below:

6.71 Corporate Participation in the Securities Exchange.- As mentioned earlier, it is expected that one of the initial activities of the Securities Exchange will consist in providing for securitized short term debt issues for corporate borrowers. Inasmuch as some corporate borrowers will be unaccustomed to providing financial information to the public, the development of a legal instrument which can permit these companies to issue debt instruments would be a "fideicomiso" or trust. These trusts are currently provided for in the Commercial Code. The only modification needed would be to review resolution #293-5/90 of the Central Bank of Honduras with respect to necessity and implementation of reserve requirements for such an instrument. This instrument would permit corporations to issue debt instruments against the published financial statements of the trust (fideicomiso) and/or the administrating bank trustee in the event that the issue were guaranteed by the bank.

6.72 Debt Instruments.- The draft of the securities exchange law mentioned above contains several amendments which must be made to the Commercial Code in order to facilitate the development of securitized transactions.

Eliminate the limitations to the negotiability of debt instruments, particularly the restriction set forth in article 503 with regard to bearer instruments.

Simplify the procedures for replacing and reissuing instruments.

Establish in the law the presumption of "good faith" of the purchaser of a debt instrument through the Securities Exchange.

Make explicit the principle that the right to issue instruments is available to all legal persons (both natural and corporate).

Establish in the law the recognition that instruments which are not explicitly described in the legislation can, in fact, be created and utilized.

Permit the issuance of instruments guaranteed by financial institutions.

Permit the negotiability of bank certificates of deposit. The instruments should be granted "executive"[15] character under the law. This will provide for a more expedient legal collection process in the event that a bank were to default on payment.

Article 6 of the law of the Central Bank of Honduras must be modified to permit the Securities Fund of the Central Bank to invest in a broader range of securitized instruments. This would open the door for insurance companies, which are potentially important institutional investors, to participate more broadly in the exchange. Insurance companies are presently limited, under article 38 of the Ley de Instituciones de Seguros, to investing only in instruments approved for the Securities Fund of the Central Bank. Eventually, as the market becomes more liquid it may be appropriate for the Fund to be permitted to invest in equity instruments.

6.73 Internal Regulations of the Securities Exchange.- The Securities Exchange should establish comprehensive regulations as to what types of negotiable instruments can be accepted for trading on the exchange, whether they be debt instruments or equity instruments, whether they be issued individually or in series. The "Rules for the Securities Exchange" issued by the President of Honduras in February, 1988, and, therefore, the present internal regulations of the Securities Exchange establishes that the only instruments that can be traded are those which have been issued in series and that have been duly registered by corporate issuers.

These restrictive requirements need to be made more flexible to permit companies which are duly registered to issue securities through the exchange which are not issued in series, as well as permitting the trading of individual securities by companies that are not registered. With this reform there will then exist the possibility that holders of debt instruments different from those registered can, in fact, dispose of them. Additionally, it will permit banks to issue securities as trustees or administrators of trusts.

6.74 Government Seat on the Securities Exchange.- Article 18 of the "Rules for the Securities Exchange" provides for the Honduran Government to have a seat on the exchange. It may be convenient for the law to be modified so that the seat belongs instead to the Central Bank. This will provide for a more active participation of the Government as it may choose to carry out a portion of its open market operations through this window.

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[15]"Executive" character of debt instruments refers to certain provisions of Civil Law wherein the instrument is immediately recognized by the judge as a valid instrument without requiring prior verification of legitimacy, signatures, etc. Typically, in Civil Code jurisdictions, the legal process for collection of instruments which are not "executive" documents is extremely tedious and costly.

6.8 Specific recommendations for Capital Markets.-

- o Develop and implement a training program for the management and staff of the securities exchange as set forth in paragraph 6.5, above.

- o Facilitate the establishment of a commission to study and propose immediate partial reform to the existing legislative and regulatory framework as set forth in paragraph 6.6, above.

- o Carry out the specific legal recommendations as set forth in paragraph 6.7, above.

7.0 SUPERVISION OF FINANCIAL INSTITUTIONS

In this section of the report special attention will be paid to the role of the Superintendency of Banks with regard to the banking system. The Superintendency also supervises insurance companies, savings and loan associations and bonded warehouses. Throughout the discussion emphasis will be placed on providing specific proposals for action by the Honduran policymakers.

In the immediate short term there is a need to solve four basic problems which, in varying degrees, have affected most of the financial entities that comprise the Honduran financial system:

1)- An almost generalized deficiency of bank capital adequacy manifested through high debt/capital ratios.

2)- A high level of past due loans which will require immediate changes in bank policies for credit initiation, credit administration and remedial management.

3)- A noticeable inadequacy in the banks' provisions for doubtful loans.

4)- A high level of concentration of loans to borrowers who are participants in the same economic group that comprises the ownership and control of the lending bank.

7.1 General Comments on the Superintendency.- One of the most interesting observations is the relatively high level of professional capability in the organization, especially when comparing it to other entities in Latin America and in other developing countries. This professionalism has been noticed by the Honduran bankers who, almost unanimously, expressed their perception of the significant progress made within the Superintendency over the past ten years. In, general, the bankers also extended their favorable opinion regarding the high ethical and moral standards of the Superintendency's professional staff.

Therefore, if the Superintendency can be provided with adequate resources, there exists the potential to transform the Honduran superintendency into an entity which can effectively fulfill tasks of prudential regulation and supervision of the financial institutions in the system.

7.2 The Organization of the Superintendency and its Legal Powers.- Significant organizational and legal changes, as well as the allocation of financial resources, technical assistance and training will be required in order to translate the Superintendency's potential into reality.

In the legislative area, amendments to convey a significant increase in the attributes, power and autonomy of the Superintendency will be needed. At the same time, in order to insure the necessary transparency and the appropriate disclosure of certain information, which the public has a right to know, it will be necessary to re-define the existing interpretation of the concept of "bank secrecy".

Currently, action by the Superintendency is limited to "formulating recommendations" that are not necessarily adopted by the supervised financial institutions. At the same time, the concept of "bank secrecy" is taken to such an extreme that practically all bank activity and data are subject to the most rigorous confidentiality. This confidentiality is even applied to financial statements and reports from external auditors.

7.3 The need for Disclosure of Information.- This extreme confidentiality seems paradoxical in view of the inexistence of any form of deposit insurance. Thus, depositing in a Honduran financial institution, in fact, becomes an act of blind faith in the institution's ability to safeguard financial assets or on the government's willingness to provide support to any collapsing bank. Although the government did, after much confusion and many false starts, pay off depositors in the recent case of the demise of Banco Financiera Hondureña there is no indication that the government is, in fact, prepared, or financially capable, of providing deposit support to the Honduran public. While the public may perceive an implicit guarantee as a result of the government's action with the Banco Financiera Hondureña, there is not at this time any fund, or any contingency provision, to support the public's deposits. It would, therefore, appear that application of the rule of "caveat emptor" would be appropriate for the depositing Honduran Public. This makes the need for transparency and financial disclosure imperative.

When strictly interpreting the law, the concept of "bank secrecy" applies only to information regarding deposits at the banks. The broad interpretation currently given to the concept by bankers has been self serving in that it has enabled the financial institutions to avoid close scrutiny of their operations and thereby, to some extent, indirectly thwart the Superintendency's ability to supervise the system effectively.

The position of the regulators with respect to disclosure is currently equivocal. While they acknowledge the public's right to information which will enable them to make an informed choice with regard to selection of an entity to safeguard their financial assets (minimal balance sheet information is published periodically by financial institutions), they are particularly concerned, given the lack of deposit insurance, that if negative information on some of the existing problems of financial institutions is made public a resulting financial panic could cause the government significant unwanted problems. As a result, immediate and forceful action to correct problems in the banking system are postponed. Unfortunately, when left alone such problems generally get worse rather than better.

In summary, if the Superintendency were granted more **power to act and enforce** and the public were given **better access to information** significant progress would be made in improving the quality of bank supervision in Honduras.

7.4 Methodology.- On the surface, the methodology applied by the Superintendency appears to be correct. However, there exists an exaggerated degree of formalism in the approach which prevents effective decision making and action where required. Fortunately, a major overhaul to the Superintendency will not be required; by strengthening certain areas, incorporating new analytical methods and taking advantage of available technical support a modernization process can effectively be carried out.

The main areas to be strengthened are:

* Financial analysis of financial institutions

* Credit review and asset evaluation

* Monitoring of economic groups and lending to related parties

In the area of financial analysis, the principal task is to strengthen analytical skills within financial institutions and within the Superintendency and to generalize among professionals in Honduras, (accountants, lawyers, bankers, regulators, etc.,) the use of financial analysis as a criteria for the evaluation of companies. At the same time, the analytical process within the Superintendency should be broadened to include **qualitative** evaluation of the credit administration procedures, remedial management procedures, credit policy and procedures and internal control procedures.

With regard to asset evaluation, and particularly with regard to loan classification, the Superintendency has made commendable progress. The principal recommendation in this area is for the Superintendency to place the responsibility for maintaining appropriate asset classification on the banks themselves. Thus, the audit emphasis of the Superintendency would be to review each bank's **credit process management**. It will be necessary for the Superintendency to establish complete guidelines for what is expected of the financial institutions.

This transfer of responsibility will not only take a great deal of the inspection burden from the Superintendency inspectors, but it will also allow for the development of a more rigid discipline, and higher credit administration standards, within each financial institution.

In order to improve the Superintendency's portfolio evaluation methods significantly, data processing and computational support are needed. The development of a centralized credit bureau to consolidate each borrowers overall level of exposure in the banking system is critical to help:

-banks evaluate borrowers during credit initiation process,

-banks, **and the Superintendency,** evaluate exposure to business groups

Honduras is not immune from the complex problems often encountered in developing countries as a result of common ownership and managerial relationships existing between some banks and large business groups. It is often difficult for an outside observer to understand the implications of these relationships and, as a result, the partnership interests resulting from these relationships have contributed to destabilization and weakening of entire banking systems in recent years, (Spain, Colombia, Chile, etc.). Therefore, in addition to improving credit information in the system through beefing up data processing capabilities, it will be necessary to confer sufficient attributes and power on the Superintendency so that it can act with alacrity and confidence to prevent abuses.

Rather than attempting to legally define the concept of "related parties" into a law or regulation to be strictly implemented by the Superintendency, any written guidelines given to the Superintendency should be in the nature of a **broad mandate** to prevent abuses resulting from related party credit transactions. In other words, the "spirit" of any regulatory or legislative actions in this area should be clear; interpretation should be left to a strengthened Superintendency. The reason for this is that it is difficult to draft a regulatory or legal text that will effectively encompass all of the possible ways in which related parties may be intertwined. Any attempt to set forth in writing when parties are related, and when they are not, will result in creating more loopholes for abuse.

7.5 Organizational Changes.- It is recommended that certain organizational changes take place within the Superintendency. Specifically, the creation of three additional units will be required:

A fully staffed Legal Department

A Data Processing and Systems Department

A Policy and Standards Department

The Legal Office must be highly specialized in bank legislation and regulations and must have a permanent character. Not only should it be able to interpret existing law related to banking issues but it should also be a source of on-going reform of banking legislation.

The Systems Unit must take advantage of available technical assistance to develop a data base and reporting capability which will enable management at the Superintendency to pin-point problems within the financial institutions and facilitate monitoring of efforts to correct those problems. The emphasis here is on developing information useful for **managerial decision-making**.

Finally, the Policy and Standards Department will serve as an agile mechanism to provide prompt and precise information, on a consistent basis, to the Superintendency staff and to the regulated institutions so that there is a clear understanding of the regulations in force, **and as to the spirit of existing regulations.** Where ambiguity in the interpretation of policy and guidelines is detected, the Policy and Standards unit can clarify the intent of the regulations. Close coordination with the legal department will be necessary.

7.6 Personnel.- Staffing of the Superintendency appears to be adequate with regard to the number of personnel. However, training to upgrade skills in various areas is needed. The recruitment of additional, trained personnel is necessary for both the legal and data processing system areas.

The principal areas in which training is required are the following:

Financial analysis of financial institutions

Corporate financial analysis (cash flow and project finance)

Asset evaluation techniques (credit review procedures)

Analysis of economic groups

Data processing, financial control and development of reporting systems useful for decision making

Traditional audit techniques

Due to the characteristics of the existing personnel and the specialized nature of the work carried out, training must be an applied and practical activity with work being monitored by the instructor. Therefore, on-the-job training will be required. However, it is recommended that formal classroom training be given as the first phase of an overall program to develop human resources.

7.7 Data processing and computational support.- As stated earlier, systems and data processing support are essential to any modernization effort to be carried out at the Superintendency. Although recent efforts have been made to improve capabilities in this area, it is felt that data processing support is almost non-existent in comparison to the needs.

The types of hardware and software required cannot be specified before designing the information system that will be used. The emphasis to be conveyed here is on **planning**. In all likelihood, the system to be designed will require a centralized configuration of medium magnitude able to manage a relatively large data base. Room for growth must be allowed for in the planning process. Access to the centralized data base by microcomputer will be desirable thereby enabling analysts and inspectors to the manipulate data available in the centralized system on spreadsheet software.

In any event, it is extremely important that before any acquisition of equipment, or software, take place the institutional requirements be clearly defined and the information system be designed. For example, if electronic reporting by financial institutions is to be implemented, an appropriate configuration must be designed. The absolutely worst strategy to follow is to acquire the equipment and then begin designing the systems and their utilization.

7.8 Specific Recommendations for the Superintendency of Banks

- Establish and implement clear, written guidelines and definitions for the banks so that periodic information submitted to the superintendency is uniform and can be utilized for effective monitoring of the banks' asset quality and financial health.

- Modify current strict interpretation of bank secrecy law so that there is ample disclosure of information regarding the financial health of financial institutions, to include information that will permit analysts to assess the quality of loan portfolios, other assets and earnings. Periodic reports by independent external auditors should be required and should be available to the public upon request.

- o The Superintendency of Banks should establish clear minimum guidelines for **Credit Process Management** requirements at financial institutions. Standards must be set for information required to be available in credit files and other credit administration procedures. Standards established must be audited periodically in conjunction with asset/loan quality review. Banks with sub-standard credit process management must be sanctioned and forced to adhere to minimum standards.

- o Banks should be required to establish internal credit review programs as part of their **Credit Process Management.** Existing loan classification standards should serve as the basis for each bank's credit review program. The Superintendency should, in turn, conduct periodic credit reviews to audit the programs established by the banks. As part of the credit review, the Superintendency must assess the adequacy of each bank's reserves set aside for loan losses. Banks must immediately establish any provisions required by the Superintendency as part of the credit review.

- o Specifically, the Superintendency should require that financial institutions write off their worthless investments in CONADI

- o The Superintendency should develop a practical **implementation plan** for dealing with sick financial institutions. Certain legislation which inhibits the power of the Superintendency to act swiftly and forcefully to intervene must be re-written. The implementation plan must address how runs on deposits will be handled and how to deal with the stockholders of the intervened institutions.

- o Once the plan is in place the Superintendency should move forcefully to intervene, liquidate or merge the existing financial institutions in the system that are failing.

- o Tax legislation must be overhauled to permit banks to deduct loan losses and provisions for losses from taxable income.

- o Conduct a computer systems review to determine optimum hardware and software requirements of the Superintendency needed to manage the desired data base. The system should be designed to permit electronic reporting by financial institutions.

- o Design and implement a training program for Superintendency personnel stressing, financial analysis, credit review and asset evaluation and how to monitor economic groups and lending to related parties. Additionally, training programs should be implemented in areas such as the mathematical review of insurance premiums and mathematical reserves to permit the Superintendency to monitor the insurance companies.

8.0 INFORMAL FINANCE

8.1 Introduction.- Informal Financial Markets (IFMs) are widely discussed and poorly understood at the present time in Honduras as well as in many other developing countries. The lack of clear understanding of IFMs is, in large part, a result of the wide variety of phenomena that can be included in this sector and the consequent difficulty that researchers have in defining and studying IFMs. For the purposes of this chapter, IFMs are defined as market transactions involving the creation of financial assets and liabilities contracted without the intermediation of formal financial institutions. These financial assets and liabilities therefore do not appear on the books of banks, savings and loan associations or other formal financial institutions.

The purpose of this chapter is to describe the agents that function as part of the IFMs in Honduras in terms of their financial services, their modes of operation and the clients they serve. The terms, conditions and uses of loans, users, alternative financing methods (private placements, supplier and buyer credits, remittances), the regulatory framework under which different informal financial agents operate, and the relationship between formal financial institutions and informal lenders are investigated. Interviews with individuals, firms, researchers and policy makers in the private and public sectors form the basis for this discussion. These informants include a wide variety of individuals, firms and institutions that undertake a significant amount of informal financial activity. Some of these are individual and corporate moneylenders, pawnbrokers, friends and relatives, and merchants of all kinds (input suppliers, traders, millers and/or processors of agricultural commodities, retailers and wholesalers). In addition, credit unions, agricultural cooperatives, and non-government organizations (NGOs) are included as part of the informal financial sector. Many of these firms and institutions may be considered informal in terms of their financial market activity, while at the same time they function as formal institutions for other business activities.

As indicated above, an important characteristic of IFMs is that their transactions escape the review and control of monetary authorities such as central banks and other regulatory agencies, whereas formal financial institutions are subject to these controls. This freedom from central bank regulation is the characteristic most frequently mentioned as the essential difference between IFMs and the formal financial market. Agents operating in IFMs are often subject to regulations such as those found in the commercial code governing contracts, promissory notes and mortgages, but they are seldom subject to monetary regulations such as interest rate controls, reserve requirements, and reporting and audit requirements. In Honduras, however, IFMs are not totally exempt from financial regulation. Honduras is, in fact, a rather exceptional case wherein moneylenders are subject to interest rate controls and loan reporting requirements in addition to commercial regulations. Honduran moneylenders are required to register with the BCH and must pay taxes on their financial transactions. Only duly registered moneylenders enjoy access to the court system for adjudicating claims and/or broken contracts. The benefit of having access to legal enforcement of contracts is apparently sufficient to offset these agents' recalcitrance about registering and paying taxes on transactions, and most do register.

8.2 The Importance of IFMs in Honduras.- IFMs account for a large and increasing share of financial activity in Honduras. It is not possible to place a firm estimate on the size of this sector, however, because of the problems of defining what to include in the sector, the complexity of the sector and the fact that information on the amount of activity is difficult to obtain from many of its participants. In countries such as Bolivia and Peru, IFMs are estimated to account for the bulk of financial activity. While it is unlikely that IFMs dominate in Honduras as they do in those countries, available data and extrapolations to the sample of intermediaries for which data were not available (particularly traders and input suppliers) lead one to expect that the amount of finance that informal intermediaries provide is very large, perhaps close in size to that of the formal sector, and IFMs clearly serve a larger number of clients than does formal finance.

Many types of agents such as individual and corporate moneylenders, finance companies, leasing companies, credit card firms, NGOs, credit unions, traders and merchants of all kinds, pawnshops, and agricultural cooperatives operate in this sector. Some important characteristics of each of these types of agents are outlined below:

> Individual and Corporate Moneylenders -- A total of 1,205 moneylenders are registered with the Superintendency of Banks, over 90 percent of which are individuals. There is a wide range of loan sizes (L1,000 to L200,000), but most loans are for amounts less than L10,000. Loan terms typically range from six months to one year, though there is tremendous flexibility on the part of these agents in accommodating the needs of clients. Legal interest rate ceilings are 18 to 24 percent per annum, but these are circumvented through fees and charges, and the going interest rate for preferred customers at the time of the study was 3.5 percent per month. The aggregate loan portfolio for registered moneylenders is estimated to be L.200 million.
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> Finance and Leasing Companies -- These are, effectively, a subset of the moneylender category above, comprising those moneylenders who are corporate in structure. Some are owned by commercial banks, or by credit card companies that are, in turn, owned by commercial banks. These firms attract significant amounts of funds from private savers who thereby enjoy a high rate of return (1.5 to 2 percent per month) on their funds. This rate of return -- about twice the formal sector deposit rate -- must, however, compensate savers for the higher degree of risk attendant in placing funds with these informal firms. Terms and conditions for lending are similar to those described above for other moneylenders.
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> Traders and Merchants -- Trade credit is an important form of informal credit in Honduras, especially for retailers and wholesalers who use short term trade credits from manufacturers and/or suppliers to finance their inventories of goods. Interviews with retailers of small consumer items indicated that terms of 15 to 30 days are common, with no interest if goods are sold during that time, and the goods serving as collateral for the loan. Agricultural input dealers supply credit to farmers for seeds, fertilizer, chemicals, machinery, etc., at 2 to 3 percent per month. Retailers of consumer durables also frequently provide credit to buyers at 2 to 3 percent per month, with terms ranging from 12 to 24 months. While the total amount of finance provided by these agents is assuredly very large, it cannot be determined precisely without a major research effort.
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> Pawnshops -- These are widespread in Honduras, with about twelve operating in Tegucigalpa, one of which is owned and operated by the Government. Jewelry, telephone lines, cars, machinery, tools, televisions, stereos and other household goods are commonly accepted as collateral for loans. Most loans are for L. 50 to 100, but some loans of L. 1,000 or more are also made. A typical loan is for 60 days, but can readily be extended as long as the borrower pays the interest. In case of default, the item is sold for the pawn value plus accrued interest -- or more. Pawnshops use owner financing as the principal source of funds,

but some also accept outside funds. Pawnshops typically pay 3 percent monthly on funds from investors and charge 10 percent monthly to borrowers.

Non Government Organizations (NGOs) -- Honduras has about 35 NGOs providing technical assistance, training and credit to small and micro-enterprises, most of which do not enjoy access to formal financial institutions. Since these NGOs started functioning, they have reached a cumulative total of about 13,000 clients, or 10 to 15 percent of their target population. The number of borrowers served by these NGOs each year (probably less than 4,000) is also very small relative to their target population. NGOs have lent approximately L.44 million through these programs since their inception, with their annual lending amounting to between L.10 million and L.15 million. Interest rates on loans from NGOs range from 12 to 36 percent per annum.

Cooperatives and Credit Unions -- These are an important source of finance for agricultural producers and small-scale enterprises. Agricultural cooperatives provide credit to farmers for inputs as well as for marketing output. Credit unions have enjoyed significant growth in loan portfolios and membership during the past five years. For 83 credit unions, the number of members increased from 40,555 to 73,947, while deposits doubled in real terms between December 1985 and June 1990. The aggregate loan portfolio of these credit unions stands at L. 135 million. Interest rates charged on loans (19 percent per annum) and paid on deposits (9 percent per annum) are low relative to other agents in the informal sector and are far below inflation for 1990. Although share capital requirements raise effective interest rates on loans to levels above stated rates, they are still negative in real terms.

Cooperativas -- While rotating savings and credit associations (ROSCAs), which are highly popular in most developing countries, were not found in Honduras, there was a widespread alternative serving much the same function. These are the "cooperativas," voluntary savings clubs where members deposit money on a regular basis and borrow funds when needed. Like ROSCAs, these "cooperativas" consist of relatively small groups of people who are interested in saving and borrowing, but unlike ROSCAs, the borrowing does not rotate among the members according to some pre-determined plan. These "cooperativas" tend to be very popular among office workers and other employees of private firms and public institutions that pay employees monthly.

The large number of agents in Honduran IFMs, in combination with the relatively small size of any individual agent, suggests that IFMs are contestable markets and not the monopolistic, exploitative markets that they are often perceived to be. New competitors can enter the market with little capital, know-how or regulatory barriers to entry.

8.3 Recent Studies of IFMs in Honduras.- A number of recent studies have been made into the use of informal finance by several types of businesses and individuals in both the urban and rural areas of Honduras. A 1987 study of urban small industries by Goldmark et al. covering firms that were already receiving bank credit found that five of 47 firms surveyed had borrowed from moneylenders and four had used supplier credit. Informal loans ranged from L.100-15,000 with terms varying from one month to two years. Interest rates ranged from 1.5 to 2 percent per month with one case of 10 percent flat for 50 days (an annual rate of 100.5 percent). A 1989 market survey by Mario Pfaeffle of 1,000 small and micro-enterprises located in San Pedro Sula and Tegucigalpa with manufacturing activities in shoe making, clothing, food and wood found that only 25 percent of these firms had received credit. Credit was obtained most frequently from NGOs (50%), followed by banks (20%), cooperatives (10%), and moneylenders (20%).

A 1984 study by Miguel Loria and Carlos E. Cuevas covering marketing channels and financing at the farm and wholesale levels for basic grains indicated significant use of informal credit. During the two crop seasons covered, only 6 percent of the Honduran farmers surveyed received credit from formal financial institutions, but 10 percent reported receiving cash advances (anticipos) from intermediaries, for an average amount of L. 1,648.00 and 2.6 months before the harvest on average. About half the intermediaries reported giving cash advances, mostly from two to five months before the harvest. These merchant/intermediaries had several sources of funds, including own resources (48 percent), formal loans (40 percent) and informal sources (12 percent).

In 1989, the Financial Development Fund (FDF) completed a survey of credit sources for farmers who were members of cooperatives belonging to the federations FACACH, UNIOCOOP, CCC, and ANACH. Taking cooperative credit to be an informal arrangement, informal sources of credit far exceeded formal sources for these farmers. The proportion receiving cooperative credit was 68, 83, 81, and 53 percent, respectively, from FACACH, UNIOCOOP, CCC, and ANACH. Only 5 percent of the farmers surveyed reported using merchant credit or family credit, and no farmers reported use of moneylender credit. The study cautions, however, that farmers may be reluctant to speak of borrowing from moneylenders.

8.4 IFMs in the Honduran Context.- Although Honduras has had informal financial activity for many years, the increasing amount of activity may be a function of repression in the formal financial sector. As discussed in other chapters of this report, problems of increasing inflation in recent years (approximately 35 percent in 1990) together with various government interventions have seriously disrupted formal financial markets. Such policy interventions as regulated interest rates on loans and the consequent reduction in interest rates on deposits, restrictions on foreign exchange transactions, high reserve requirements, and targeting of rediscounted loans all help to force financial activity into IFMs which are not subject to these controls. As the rate of return on funds placed in the formal system becomes increasingly unattractive and as the formal financial sector shrinks, individuals lose confidence in their continued access to credit and begin to seek other means of saving and borrowing. In this environment, IFMs offer an opportunity to earn higher returns on financial assets and more assured access to credit.

While financial repression creates economic losses even when alternative (informal) financial arrangements arise to satisfy demand, this loss is greater or lesser depending on the efficiency with which suppliers of informal financial services satisfy the demand for intermediation. It is argued below, however, that even with liberalization of financial markets in Honduras, there would still be significant demand -- particularly among small and rural enterprises -- for informal financial intermediation. Some of the benefits that informal arrangements afford such participants in IFMs are described below.

8.5 Advantages for Borrowers.- Interviews with borrowers and lenders revealed a number of reasons why they choose IFMs over formal financial institutions. Perhaps the most important reason is access to credit for borrowers who do not qualify for access to funds from the formal sector. A high percentage of the borrowers from the informal sector do not meet formal lenders' banking requirements (e.g., character and collateral).

Borrower transaction costs in terms of time costs and travel costs are also lower in IFMs because informal lenders tend to be located closer to the borrower and their loan processing requirements are less demanding for the borrower. At the same time, informal lenders themselves enjoy lower lending transaction costs (higher operational efficiency) in their small scale transactions. This efficiency derives largely from economies of scope that agents in IFMs are able to realize. Because these agents know their clients both socially and, often, through other business dealings, they have information about their clients that reduces their need for additional information and their loan supervision costs. The low lender and borrower transaction costs of IFMs differ sharply from the transaction costs of formal financial markets where the lender costs are higher and the borrower transaction costs -- the non-interest costs of borrowing -- often exceed the interest costs for a small loan.

Borrowers like the flexibility and timeliness that IFMs offer compared to the formal sector. The fast, simple loan application and disbursement procedures allow the borrower to know quickly if the loan is approved and to receive the money rapidly. Informal lenders are also highly flexible in accepting a wide variety of guarantees, in addition to conventional mortgages, by which to secure loans. They can also vary loan size and duration quickly to fit a broad range of borrower needs. Interest rates charged by informal lenders range from about 2 to 4 percent monthly for most borrowers, but can be as high as 10 to 20 percent daily for the small one-day loans typically made to merchants in market areas. Borrowers consider the access to funds in combination with the correct size and duration of a loan to be more important than the higher interest rates charged by agents in IFMs. Longer hours and friendlier, more convenient service also attract many borrowers to their services.

8.6 Advantages for Savers.- Savers with funds for "deposit" appear to choose IFMs primarily because of the higher interest rates that can be earned on those funds. Savers may also choose IFMs because the confidentiality of deposits facilitates the evasion of income tax payments on interest earnings. Individual and corporate moneylenders accept funds as well as lending funds to the public. Some of the corporate moneylenders that attract significant amounts of funds from private savers include finance companies which, in many cases, are owned by commercial banks, credit card companies owned by commercial banks, or leasing companies. The interest rates paid to savers -- which, at 1.5 to 2 percent per month, are twice the rate in formal financial markets -- have to reflect all the saver's costs including the higher risk of placing funds with IFMs. The risk of loss on these funds is likely to be higher than for bank deposits, but during the field work it was not possible to specify precisely the extent of this risk. Positive incentives to save (e.g., higher returns on savings) in formal financial institutions would reduce the risk of loss in IFMs and increase government tax revenues on interest earnings.

8.7 Interventions in IFMs in Honduras.- The reasons why borrowers and lenders choose to operate in IFMs indicate that IFMs do serve and are likely to continue to serve more clients than formal financial institutions. Furthermore, there are important lessons to be learned by the formal financial system from the financial services provided by IFMs. The formal banking system could serve more of these clients with more aggressive deposit mobilization, simpler loan application procedures, an improved disbursement and collection process, and more attention to retail banking under a different ownership structure. As discussed elsewhere in this report, the current ownership structure of most commercial banks in Honduras fails to create the appropriate incentives for banks to pursue retail banking aggressively. This occurs in large part because the primary purpose of many commercial banks appears to be serving the borrowing needs of the other businesses of the bank's owners at low rates of interest.

USAID and other donor agencies currently have projects involving certain IFM agents in attempts to reach larger numbers of small savers and borrowers at lower cost and to expand the overall scope of financial services in urban and rural areas of Honduras. The primary beneficiaries of this support have been credit unions and NGOs that serve a small- and micro-enterprise clientele. These projects and their effects on the participating intermediaries are discussed below.

8.8 Assistance for Credit Unions.- The USAID Small Farmer Strengthening Project that involves credit unions and agricultural cooperatives represents an important intervention strategy designed to strengthen these institutions through technical and financial assistance in order to reach borrowers and savers who currently do not enjoy access to formal financial services. In total, these credit unions are clearly stronger than before. Membership in the 83 credit unions affiliated with FACACH increased from 40,556 in December 1985 to almost 74,000 by June 1990, and the loan portfolio grew to reach L. 135 million. The real value of share capital, deposits, loans, reserves and assets increased by 68 percent, 100 percent, 72 percent, 277 percent and 68 percent, respectively, during this period. Moreover, based on these same indicators, the 11 best credit unions performed much better than all 83 credit unions, thereby indicating significant potential for future efficiency gains throughout the credit union system. Many of the other credit unions have financial and management problems that are to be addressed with assistance from the project. In addition, all credit unions need to adopt policies of paying positive real interest rates on deposits and charging positive real rates on loans, while also improving their business management systems.

8.9 Assistance for NGOs.- Donor assistance to NGOs is another intervention strategy to reach small and micro-enterprise borrowers that do not have access to the formal financial sector. The Small Business II project of USAID proposes to strengthen and expand the NGO system to increase and improve the supply of credit, training, technical assistance and services to small and micro-enterprises. While the efforts of these programs are admirable, currently they reach only a small percentage (probably fewer than 5 percent per year) of all the small and micro-enterprise borrowers in Honduras. The 35 NGOs with lending programs have lent about L. 44 million to about 13,000 clients over the life of these projects (which in some cases exceeds 15 years). Furthermore, these NGOs do not seem to be making rapid progress toward increasing the outreach of their lending programs. They are neither charging sufficiently high interest rates on loans nor resolving the problems of past due loans that are needed to achieve financial self-sufficiency.

The NGOs could become an important link between IFM clients and the formal financial system, and thereby reach much larger numbers of small borrowers, if the NGOs themselves could achieve financial self-sufficiency. Financial self-sufficiency requires that the NGOs put in place revenue increasing measures (e.g., higher interest rates) and cost reducing innovations (e.g., improved loan recovery) that will allow them to cover their costs of lending. Although the NGOs are currently dependent on donor financing, improved self-sufficiency could permit them to borrow from commercial banks (like any other commercial borrower), lend to the micro-enterprise sector, collect payment from their micro-enterprise borrowers and repay the commercial banks.

8.10 Other Avenues for Supporting the IFM Clientele.- The overall performance of the financial system could be improved through policies that reward the holding of financial assets in the Honduran banking system and by pursuing policies to stabilize prices in Honduras. Elimination of interest rate regulations and high reserve requirements would create stronger incentives to save and borrow through the formal financial system. Complete unification the foreign exchange regime would reduce the incentives for capital flight and give greater opportunity for both the formal and informal financial systems in Honduras to operate efficiently. Accomplishing these policy reforms would encourage the formal system to serve more borrowers and savers who are currently IFM clients and thereby improve the overall allocation of resources in the economy. Even though IFMs provide important financial services for their clients, integration of these clients into the formal system would improve allocative efficiency in the economy. The government should also seek ways to enhance the performance of IFMs through policy incentives that improve all financial markets rather than imposing regulations that inhibit participation in IFMs. Although interest rate controls on moneylenders may be politically popular, such controls have negative consequences for the financial system and especially for the intended beneficiaries of controls.

Increases in trade credits could become a particularly important link between IFM clients and the formal financial system that could reach large numbers of small borrowers. Merchants and traders currently serve far more small and micro-enterprise borrowers and savers than any of the other IFM agents studied in this report. These marketing intermediaries often have difficulty obtaining adequate financing from banks because of policies and biases against commercial credit compared to industrial credit or agricultural credit. Removing these obstacles to trade credit could increase significantly the flow of funds from banks to traders to small borrowers.

8.11 Main Conclusions.- IFMs provide useful services to a wide range of small-scale clients throughout Honduras and are likely to continue to do so even if the formal financial sector is liberalized. In addition to the moneylenders, pawnbrokers, cooperativas, and merchants and traders that provide the majority of financial services to these clients, NGOs, credit unions and agricultural cooperatives have considerable potential for improving access to finance if their own financial viability is improved.

While it is not possible without extensive surveys to quantify precisely the volume of financial services provided by IFMs, it is clear that they serve more clients than the formal sector and that they have enjoyed increasing activity in recent years. The main reason why IFMs have been so successful in expanding their business even as the formal financial sector contracts is that they are able to avoid many of the counter-productive rules and regulations that have constrained the formal sector while also offering financial services that a wide range of clients find highly attractive.

Among the most important characteristics of IFMS are the extremely wide variety of agents involved and services provided and the largely competitive nature of the market. Although interest rates on loans may appear high in some cases, they reflect the relatively high costs and risks involved in lending to many IFM clients. Moreover, the innovative techniques typically employed by agents in IFMs have reduced transactions costs for borrowers to the point that the interest and transaction costs combined are often lower in IFMs than in the formal financial sector, especially for small loans for short periods of time. It is therefore likely that, formal sector financial liberalization notwithstanding, IFMs will continue to serve many of the financial service needs of the small-scale agents in the Honduran economy.

Among the most important advantages for clients that have contributed to the success of agents in IFMs are speed in delivering services and flexibility not only in loan sizes and terms but also in acceptable security for loans. In addition to the advantages for clients of IFMs, agents in these markets enjoy an important advantage over their counterparts in the formal financial sector in lower lender transaction costs (higher operational efficiency) for small scale transactions. This efficiency derives in large part from lower information and supervision costs due to the agents' close ties to and better knowledge of many of their clients.

On the other hand, in order to attract funds, IFMs must offer higher interest rates than formal financial institutions because of the apparent higher risks. The lack of adequate supervision of agents in IFMs that take investor funds in fact reflects a greater danger to the Honduran economy in general and to the financial sector in particular than the occasional cases of excessively high non-competitive interest rates on loans. Moreover, with appropriate policies with respect to the formal financial sector, especially involving interest rate controls, formal financial institutions should easily have greater efficiency in deposit operations and thus be able to out-compete IFMs in mobilizing funds.

8.12 Specific Recommendations for IFMs.-

- It is clear that far too little is known about this major component of the Honduran financial system, so that any additional studies of financial markets in Honduran should give high priority to both surveys and case studies of IFMs.

- Any additional regulation of IFMs in Honduran should focus on protection of investor funds and should not inhibit competition and innovation in IFMs through attempts at enforcing interest rate controls or similar regulations.

- Interventions to strengthen specific agents in Honduran IFMs should focus on making these agents financially viable and should not involve them in programs to strengthen their clients that are patterned after traditional directed credit programs.

- Agents in IFMs can provide better service to their clients if they can obtain credit from the formal system on competitive terms, and this should include pawnbrokers, marketing agents and other informal lenders and not just credit unions and NGOs.

9.0 SUMMARY OF RECOMMENDATIONS

9.1 A Strategy for Financial Sector Development.-

Broadly speaking, the following overall guidelines should characterize efforts to reform the financial sector of Honduras.

- o Implement fiscal policies which will permit the government to operate with a balanced budget. To the extent possible, the financial sector should not be utilized as a source of incremental financing for the central government. Taxes, and other forms of financing for the central government, should be levied in a transparent manner.

- o Policies and interventions in financial markets and capital markets should be directed at removing **distortions** from the financial system to permit market forces to efficiently allocate resources in the financial system.

- o Policies and interventions should be directed at fostering **competition** in financial markets wherever possible. The more competition that exists in financial markets, the more efficient the markets. In the long run, financial resources will be allocated to their highest and best use in the economy.

- o Care should be taken to insure that financial market and capital market strategy be **integrated**. This will insure the balanced development of both markets.

9.2 Specific Recommendations for Financial Sector Interventions.-

Macrofinancial Policy Reforms.-

- o Reduce the public sector fiscal deficit such that it can be financed through transparent, market-oriented means that do not crowd out the private sector and consequently undermine investment.

- o Unify the foreign exchange market by eliminating exchange controls that require exporters to surrender their foreign exchange to the BCH and importers to access foreign exchange through the BCH.

- o Attempt to assure greater independence for the BCH and allow it to use monetary instruments for monetary control rather than for financing the public sector fiscal deficit and channeling funds at below market interest rates to the private sector.

- o Improve the technical capabilities of the BCH to use the main instruments of monetary control, that is, open market operations, reserve requirements and rediscounts.

- o To the extent that interest rate controls are not completely phased out, tie them to a market rate of interest such as that determined in the auction market for government bonds where the BCH would carry out its open market operations.

- o As a first step, undertake:

    - o a parallel reduction in reserve requirement and rediscounts;

- o a movement of the rediscount rate to market levels;
- o the remuneration of remaining required reserves at market rates; and
- o the initiation of open market operations through an auction system.

BCH Operational Reforms.-

- o The focus of the BCH should be narrowed so that it is clearly responsible for monetary and financial sector policies and their implementation and not for a boarder range of economic or governmental activities.

- o The BCH should have adequate autonomy and independence which will require modification of pertinent laws, including those covering the selection of members for its Board of Directors.

- o The plan to reorganize and decentralize the BCH should be implemented, with some modifications, but only after the essential functions of the BCH have been clearly defined -- except that immediate attention should be given to improving internal controls and to developing an integrated accounting system for management information and financial control.

- o The BCH should reform its rediscount policies so that short term credits are granted to banks only for liquidity management purposes and so that procedures for granting long term credits for development purposes are reformed. In both case, interest rates on rediscounts should be high enough to cover the costs of funds (including any foreign exchange risk) and not to discourage deposit mobilization by banks.

- o The BCH should be assisted in obtaining training and technical assistance in a variety of areas, but especially with respect to the following:

- o for the Department of Economic Studies so that it can play its essential role in developing the BCH's monetary program and in providing crucial information and analysis to highest level BCH management;

- o for the Department of Credit to develop new approaches to handling rediscounts and for the initiation of open market operations; and

- o for improving internal controls and developing an integrated financial system for management information and control.

Financial Institution Recommendations.-

- o Facilitate the development of formalized, on-going training programs (described in Chapter 4, para.,4.181,) to assist financial institutions with the modernization and liberalization process that will inevitably result from policy recommendations recommended in Chapter 2.

- Provide technical assistance to the banking system, through the Superintendency of Banks, or through the Bankers' Association, to facilitate the implementation of **credit process management and credit review** related recommendations suggested in Chapter 7.

- As suggested in the specific recommendations under Chapter 4, para., 4.32, serious consideration should be given to liquidation or privatization of BANADESA. It will be difficult for market mechanisms to effectively intermediate financial resources in the agricultural sector while BANADESA continues to operate under pricing standards that are not market determined (and with different credit standards) in competition with the private sector (both the formal financial institutions and the informal financial system).

- Conduct a review of all existing legislation, Central Bank regulations and other constraints upon the banking system that inhibit open competition among financial institutions. Develop a plan to dismantle barriers to competition. The results of this survey must be incorporated into any overall plan to modernize current banking legislation.

Pension Fund and Insurance Company Recommendations.-

- Facilitate the development of a seminar, adapted to the Honduran context, on macro-financial issues, capital budgeting, bond yields and short term investment for the participation of pension plan managers and staff.

- Facilitate the development of a statistical data bank to record statistics on insurance claims. This will permit insurance premiums and reserves to be mathematically calculated.

Capital Market Recommendations.-

- Develop and implement a training program for the management and staff of the securities exchange as set forth in Chapter 6, para., 6.5.

- Facilitate the establishment of a commission to study and propose immediate partial reform to the existing legislative and regulatory framework as set forth in Chapter 6, para., 6.6.

- Carry out the specific legal recommendations as set forth in Chapter 6, para., 6.7.

Recommendations for the Superintendency of Banks.-

- Establish and implement clear, written guidelines and definitions for the banks so that periodic information submitted to the superintendency is uniform and can be utilized for effective monitoring of the banks' asset quality and financial health.

- Modify current strict interpretation of bank secrecy law so that there is ample disclosure of information regarding the financial health of financial institutions, to include information that will permit analysts to assess the quality of loan portfolios, other assets and earnings. Periodic reports by independent external auditors should be required and <u>should be available to the public upon request.</u>

- The Superintendency of Banks should establish clear minimum guidelines for **Credit Process Management** requirements at financial institutions. Standards must be set for information required to be available in credit files and other credit administration procedures. Standards established must be audited periodically in conjunction with asset/loan quality review. Banks with sub-standard credit process management must be sanctioned and forced to adhere to minimum standards.

- Banks should be required to establish internal credit review programs as part of their **Credit Process Management.** Existing loan classification standards should serve as the basis for each bank's credit review program. The Superintendency should, in turn, conduct periodic credit reviews to audit the programs established by the banks. As part of the credit review, the Superintendency must assess the adequacy of each bank's reserves set aside for loan losses. Banks must immediately establish any provisions required by the Superintendency as part of the credit review.

- Specifically, the Superintendency should require that financial institutions write off their worthless investments in CONADI

- The Superintendency should develop a practical **implementation plan** for dealing with sick financial institutions. Certain legislation which inhibits the power of the Superintendency to act swiftly and forcefully to intervene must be re-written. The implementation plan must address how runs on deposits will be handled and how to deal with the stockholders of the intervened institutions.

- Once the plan is in place the Superintendency should move forcefully to intervene, liquidate or merge the existing financial institutions in the system that are failing.

- Tax legislation must be overhauled to permit banks to deduct loan losses and provisions for losses from taxable income.

- Conduct a computer systems review to determine optimum hardware and software requirements of the Superintendency needed to manage the desired data base. The system should be designed to permit electronic reporting by financial institutions.

- Design and implement a training program for Superintendency personnel stressing, financial analysis, credit review and asset evaluation and how to monitor economic groups and lending to related parties. Additionally, training programs should be implemented in areas such as the mathematical review of insurance premiums and mathematical reserves to permit the Superintendency to monitor the insurance companies.

Informal Financial Market Recommendations.-

- It is clear that far too little is known about this major component of the Honduran financial system, so that any additional studies of financial markets in Honduran should give high priority to both surveys and case studies of IFMs.

- o Any additional regulation of IFMs in Honduran should focus on protection of investor funds and should not inhibit competition and innovation in IFMs through attempts at enforcing interest rate controls or similar regulations.

- o Interventions to strengthen specific agents in Honduran IFMs should focus on making these agents financially viable and should not involve them in programs to strengthen their clients that are patterned after traditional directed credit programs.

- o Agents in IFMs can provide better service to their clients if they can obtain credit from the formal system on competitive terms, and this should include pawnbrokers, marketing agents and other informal lenders and not just credit unions and NGOs.

10.0 LIST OF TECHNICAL SUB-SECTOR REPORTS

1. Macro-Financial Aspects of the Honduran Economy

2. Operational Aspects Related to the Central Bank

3. Legal Aspects of the Honduran Financial System

4. Report on the Honduran Pension Funds: Description, Investment Practices, and General Analysis

5. Report on the Superintendency of Banks

6. Honduras Informal Financial Markets Assessment